FINANCE AND CAPITAL MARKETS SERIES

STANDBY LETTERS OF CREDIT

A Comprehensive Guide

Jacob E. Sifri

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A COMPREHENSIVE GUIDE

JACOB E. SIFRI

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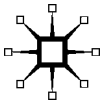

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To My Father Elia Sifri

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Foreword

Welcome to This Book 'Standby Letters of Credit – A Comprehensive Guide'. You may be aware, being involved in the commercial world of business, either as a banker or other business person, that in its traditional role, this type of letter of credit is usually issued by banking institutions at the request of a service provider, to serve as a guarantee for the beneficiary to exercise in case of any default in performance by the other party in accordance with the duly executed agreement between these two parties.

Furthermore, in addition to the above function, Standby letters of credit have developed throughout the years, and have evolved into an all purpose instrument. Such Standby letters of credit can also be employed to play the role of a Direct Pay tool through the power of which the beneficiary can simply draw funds needed to comply with the requirements of the executed agreement between the two parties.

The most obvious example is in the case of government bonds, where the beneficiary is allowed to draw either the principal amount or the accrued interest or even both on a specific day – which clearly does not involve a default of performance.

It gives me immense pleasure, as a previous mentor for the author at the commencement of his banking career, to be invited to write this foreword introducing this important book for you. This book you are about to embark upon reading is the result of some relentless work by the author Mr. Jacob E. Sifri, who has extensive banking and commercial experience in his capacity as a banker and consultant for banking institutions on issues of trade and training amongst others. He has spent some five years of his career composing this book. In his own words he describes the experience as *The best thing I have ever done in my whole life. I really did not suffer a bit whilst authoring it, to the contrary, it was such an exciting, happy and useful experience.* Such statements indicate the huge care and passion with

which this book was written, giving us the assurance of the distinguished quality of this product.

I encourage you, as a starting point, to look into this book's table of contents. This book will take you on a journey that starts with an introduction to Standby Letters of credit, with a specific emphasis on the vital role this financial tool plays in the economy. Then, the book moves into outlining the scope and application of International Standby Practices (ISP98) with an indication of the types of undertakings for which those rules were originally intended. Thereafter, the book will lead you through the different rules of this (ISP98) from the general provision, to the obligations, the presentation, the examination, the notices, the preclusion and the disposition of documents, the transfer, the assignment, and the transfer by operation of law, ending up with some arguments in relation to presentation and settlement. The book also gives some exploratory notes in relation to the cancellation of Standby letters of credit, and the reimbursement obligations, timing and syndication/participation with an emphasis on the importance of detecting and preventing fraud, which is considered a major issue in the contemporary world of business.

Different chapters of this book examine diverse issues in relation to Standby Letters of Credit. In Chapter 14 of this book, you will find a clear and informative argument in relation to risk aversion in trade operations, which is an important topic that is relevant to our day to day work in this global economy. Further, and despite the fact that globalisation is the hallmark of this era, this chapter argues that it is of vital importance, and specifically to those who are in the industry, to have a thorough understanding that trade operations are different depending on the country where these processes are carried out. Thus, there are operational risks related to these operations. There are distinctive laws in place to act as firewalls against risks pertaining to a multitude of factors that have either direct or indirect effect on the safety of financial transactions carried out in different countries. In addition to the operational risks, there are specific risks too, that are attached to such trade operations, and these specific risks are:

A. *Risks pertaining to the goods in commercial transactions;*

B. *Foreign Exchange: Borne by the applicant of the LC;*

C. *Failure of the issuing bank;*

D. *Insolvency of the Applicant;*

E. *Fraud risk;*

F. *Sovereign and regulatory risks (sometimes called country risk);*

G. *Legal Risks;*

H. *Failure to comply with the credit terms and conditions;*

I. Risks to the advising bank;

J. Risks to the nominated bank;

K. The risks on the confirming;

L. Risks to the reimbursing bank.

This entire list is tackled, in a very professional manner, in Chapter 14 of this book.

Looking at the contents of this book with my academic researcher's mind-set, it is apparent that this book (and specifically throughout the argument included in chapter fifteen, which discusses the issue of fraud) shares the aim of my research – a research that was originally triggered with the increased transgressions in the corporate world at different levels – which has a simple aim of participating in the debate that is currently raging in relation to generating and applying a more ethical mind-set in the commercial and the academic worlds.

Thus, with this book, and specifically with chapter fifteen, I was assured that authors such as Mr. Jacob E. Sifri are participating in this global debate, each in their own unique way, therefore assisting practitioners to understand the dangers of and keep their distance from fraud. This, hopefully, might assist in transforming the mind-sets of those involved into ethical mind-sets, therefore allowing for an honest commercial world, which will have its positive impact on society and in turn on the globe.

Yes, this book is a must-read for bankers and practitioners, alike.

I would like to extend my earnest gratitude to the author for his immense contribution to the banking and the contemporary business worlds. In addition, I would like to extend my cordial thanks for his incalculable trust in my capabilities, thus allowing me the chance to write this foreword for this useful book.

Finally, I wish you a pleasant and beneficial journey through the pages of this valuable book, with the hope that its contents will assist you in understanding this powerful tool of the banking and commercial worlds.

Theodora Issa, MBA, MEC, MMR

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Preface

Standby letters of credit is much too exciting to be left to professors of law and advocates alone. It is the tool that every business must come across in one way or another. Today banks maintain books exceeding hundreds of millions worth of standby letters of credit. It is becoming the instrument that almost affects every thing we see; contractors need performance standby letters of credit to construct huge towers, schools, museums, oil platforms, airport terminals, compounds, commercial markets, buildings, castles, palaces and stadiums; Governments issue them to effect payments of principle and interest of their treasury bonds and similar securities; Insurance Companies use them to compensate their insurers whenever needed … etc. The wide use of standby letters of credit around the world makes it even more challenging to study. Some say it could even replace the commercial letters of credits, a hypothesis which may turn true if an exchange mechanism that enhances the buyer's and seller's level of safety can be somehow engineered.

From a banking perspective, the operations of issuance, advising, perusing documents and settlements are truly complex. The demand to strike a balance between dwarfing risks and growing magnitude places extra burden on those financial institutions extensively dealing with standby letters of credit.

The book has two distinctive facets; empirical and theoretical. Empirical in that it analyses numerous real life case studies whilst referring to the exact procedures and actions undertaken by global banks whenever they execute a standby letter of credit transaction. It is theoretical in that it precisely explains the articles of the ISP98 (International Standby Practices). Simply, the book is designed to teach you the operational aspects of this type of documentary credits and eventually lead you to sound practice; it is a vital toolkit containing the full proven tools you need to deal with day to day routine problems and even unforeseen circumstances.

When it comes to standby letters of credit, learning by doing is the way to operate faultlessly. No one can learn basketball by reading an instruction manual. Even when you think you are an experienced legislator, professional lawyer or qualified merchant, practical experience is tantamount to academia; practice is simply imperative to master the finer points where the risks mostly disguise. This is precisely the reason for which we have included numerous real life famous cases on standby letters of credit; to help you to understand how to soundly apply the intricate provisions of the ISP98 rules of practice in day to day operations.

With its comprehensive scope, you will be surprised at how much light this empirical analysis sheds on standby letters of credit. Website www.graincon.com offers an interesting range of technical papers which supplement the subject matter of this book. I cordially urge you to visit the site for further reading.

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CHAPTER 1

An Overview

1.1 INTRODUCTION

The indubitable pivotal role of documentary credits in enabling a vast number of commercial and financial transactions has been the core subject of the esoteric work of many academics and professionals of international trade. It is almost always concluded that the sound application of the intricate provisions of the ISP98 (International Standby Practices) and the UCP (The Uniform Customs and Practice for Documentary Credits) is necessary to halt the proliferation of arduous operational hazards that may well cause banks to collapse and could even result in severe economic damage at national levels.

Documentary credits represent the vehicle without which trade across national boundaries would not take place at desirable scales. The mere enthusiasm and amicability to execute bilateral and multilateral trade covenants are insufficient to enable import/export deals. From a macro perspective, the ability to understand the mechanisms of the Letters of Credit (LC) itself and thus soundly apply the rules of the ISP98 and UCP is analogous in importance to trade conventions and agreements. Further, a huge number of non-commercial transactions within various individual economies requires the kind of security provided by standby letters of credit; a requirement that depicts its vital role around the world.

Commercial and Standby letters of credit, the most commonly used types of this sophisticated tool, have different characteristics which were evolved over historic periods of time to accommodate the need of businesses in various locations for a secured and liquid system of payment that is globally unified.

The commercial documentary credit serves as means of security provided by a bank on behalf of a buyer (applicant), guaranteeing payment for a seller (the beneficiary) whenever the latter proves that it has either shipped

goods or provided services whilst fully complying with the terms and conditions of the LC, by submitting the required set of documents in conformity with the LC's stipulations. Hence, the commercial documentary credit is in essence a definite and irrevocable payment undertaking made by a bank and executed whenever the beneficiary delivers a specific obligation indicated by the LC.

Conversely, the prime function of the standby letters of credit is to guarantee payment for the beneficiary in cases where the applicant defaults in performing a certain duty previously agreed upon with the applicant under a pre-signed agreement. Additionally, the standby LC is issued in a wide range of uses that also cover commercial transactions and direct pay commitments. For example, it may be issued by a bank to guarantee the performance of a contractor in construction projects, or simply as an undertaking to pay directly on demand a principal sum of money with or without interest. The types and uses of standby LCs will be addressed in detail in next chapters, but at this stage it is important to remember that a standby LC virtually encapsulates a wider range of uses than the guarantees, commercial LCs or any other financial instrument.

Today, standby letters of credit are used at vast scales especially in the western world. The current outstanding volumes at banks recorded a staggering $979 billion, of which $570 billion were issued by non-US banks for the US market. These figures far exceed the exposure in the commercial LCs market. The ratio of numbers of transactions between the two types of LCs currently stands at 7:1 in favour of standby LCs. The figures merely emphasize the important role this tool plays in the global economies of the world.

1.2 LIMITATIONS ON USAGE

Under standby letters of credit, the beneficiary often receives payment by preparing, signing and merely presenting a simple claim with a draft to the bank authorized to act and/or honour a claim under the standby. In developed countries this is acceptable because even if the beneficiary's claim is a fraudulent one, their healthy legal systems constantly provide the protection for the applicant; they can pursue the fraudsters quickly and efficiently. Unfortunately, the case is not so in the world's developing countries where legal procedures are often lengthy, expensive and inefficient.

Standby letters of credit can never be quite as safe as commercial letters of credit and are not commonly used in import/export deals. Nevertheless, standby letters of credit are effectively being used in a wider range of transactions that does not involve import/export deals. Frequently it is used as security for commercial lines of credit granted, for example a TV manufacturer

may need to purchase on credit large quantities of electrical devices from another electrical devices manufacturer. The seller would agree to grant the TV manufacturer a line of credit if the latter provides adequate security. The best security in this case is a standby letter of credit issued by a reliable bank on behalf of the TV manufacturer in favour of the electrical devices manufacturer (beneficiary) by which the beneficiary can regain the value of the goods supplied if and when the TV manufacturer fails to pay on due date.

1.3 GENERAL

1.3.1 Uses

While they can be structured in many different ways, standbys are typically used in situations similar to that of the TV manufacturer: a bank promises to pay the seller of a good in the event that the buyer does not meet its payment obligations as defined in the original purchase contract and/or the text of the standby itself. In exchange, the bank usually receives from the buyer a fee. In essence, the bank guarantees that the seller will be paid whenever the buyer defaults to pay.

Standby letters of credit may also be used as secondary means of payment, or as a guarantee of performance, or even as collateral in lieu of cash. Direct pay standby letters of credit are used to make regular payments of interest or principal.

You might notice the similarity between standby LCs and demand guarantees; both instruments require the presentation of stipulated documents in compliance with the terms and conditions of the text. Legally, both instruments are identical; the distinction is mainly in practice and terminology.

1.3.2 Governing Rules – the ISP98

Sometimes, standby letters of credit are issued subject only to the UCP600 rules, which were developed specifically for commercial letters of credit. More than half of the UCP articles, however, do not apply to standby letters of credit. Hence, it is much more secure to issue standby letters of credit subject to the International Standby Practices (or the infamous ISP98).

The ISP is a complete set of rules that represent the practice of international banks in handling standby LCs. It has been drafted by a group of experts and sanctioned by The International Chamber of Commerce (ICC); hence, it is globally recognized by all banks. Same as the new UCP600, the ISP98 includes definitions of terms. In addition, the ISP98 sets clear rules on procedures to follow when a standby LC requires presentation of documents by a certain day, and that day happens to fall on a non-banking

day. Under Article 29 of the UCP600, this could cause confusion and even problems for many companies. The trouble arises when a standby LC is used to guarantee a monthly payment, say, on the 27th of every month. Sometimes, of course, the 27th will fall on a weekend, and according to the UCP, if the beneficiary waits until the following Monday to draw he not only loses the right to that instalment but his entire right to draw on the LC. The UCP only allows extending the last date for presentation for the first following banking day.

The ISP sets clear rules for use of standby LCs issued to secure repayment of an instalment note that extends over a long period of time. Under the UCP, issuers have been known to deny payment of a standby LC if the buyer has already made a number of instalment payments up to that point. Also, the ISP defines rules for transfer of beneficiaries. In the next chapters we will analyze each of the ISP98 rules and precisely explain how they apply in practice.

1.3.3 Presentation and payment under a standby LC

The standby letter of credit, is often issued available for payment against the presentation of a simple letter/demand and a draft (Bill of Exchange) both of which are written and signed by the beneficiary. The bank responsible for payment must honour the claim upon receipt of the complying documents regardless of whether or not the applicant ascertains that it has performed the duties indicated by the standby. The mechanisms of the standby letters of credit will be addressed later on in detail.

At this stage it is adequate to understand that an issuing bank, a confirming bank or a paying/accepting/negotiating bank is required to check the documents on their face to determine whether or not they conform to the credit terms and conditions, and the provisions of the ISP98 if the standby is made subject to them.

If the standby is subjected to the ISP98, then the documents presented under it must comply with all of the provisions of its rules unless where any rule is modified. In such a case the portions of the rule that were not modified will apply unless of course the standby excludes the entire rule.

1.3.4 United Nations Convention on international guarantees and standby LCs

In 1995, the General Assembly of the United Nations unanimously adopted The United Nations Commission on International Trade Law (UNCITRAL) (Full text can be freely accessed on website www.graincon.com). The Convention, signed by President Bill Clinton of the United States of

America in 1997, applies only to independent guarantees and standby letters of credit as defined in Article 2 of the Convention. The Convention in essence is the predicate that almost unified the functionality of the standby letters of credit normally issued by the imminent American banks and demand guarantees normally issued by non-American banks.

The Convention would automatically apply to all standby letters of credit and letters of guarantees issued in America for example, in the case where the United States adopts it, that is, it becomes a national statute. Conversely, the ICC rules of practice only apply if they are incorporated by reference into the text of the instrument at hand.

If the parties to the credit choose to apply the Convention's provisions, such provisions would be supplemented by prevailing rules of practice such as the UCP600, the Uniform Rules for Demand Guarantees (URDG) and the ISP98. Those who read the Convention may criticize the silence of the Convention with regards to potential conflict with local laws like Article 5 of the Uniform Commercial Code (UCC) of the United States of America; of course, some may say it is implicitly understood that law is in a constant state of prevalence over all other rules and regulations that cover a similar area, nevertheless, a clear standing would always lead to precision and sound decision.

The Convention did yet receive general recognition, only a few number of countries are members in it.

CHAPTER 2

Scope and Application of the ISP98

2.1 STANDBY LETTERS OF CREDIT

In general, a standby letter of credit is a legal promise (undertaking), made by a bank (issuer) on behalf of one of its customers (applicant), to pay on demand a fixed sum of money, in parts or in whole, to a named beneficiary if and when the applicant fails to carry out a certain duty he owes to the beneficiary (defaults). In other words, a bank that issues a standby letter of credit guarantees to cover the beneficiary for losses incurred as a result of the failure of the applicant to perform his part of an agreement with the beneficiary. (Failure to perform one's part in an underlying standby agreement is normally referred to as a default situation. Of course a standby does not necessarily have to depict a default situation, but for simplification purposes at this stage we will assume that it does.)

Hence, it can be argued that a standby LC in essence is a bank guarantee. This would have been true if it wasn't for the following two major differences that distinguish one instrument from the other:

1. Unlike the guarantees, there is a special type of standby letter of credit called Direct Pay which does not normally involve a default situation, although it may do so as we will see later on. A Direct Pay Standby LC bounds the issuer to pay, merely on demand, within the letter of credit's validity period, a certain sum of money to the order of a specified beneficiary.
2. The standby letter of credit has evolved into a complex instrument that encompasses a much wider range of uses than that covered by the guarantees. On this point, it is worthwhile noting the following comment in the ICC Publication 511 Documentary Credits UCP500 and 400 Compared:

   It was agreed unanimously that the Standby letter of credit is not to be merged with the bank guarantee rules regulated by the ICC's Uniform

Rules for Demand Guarantees (URDG), ICC Publication No. 458. While the Standby Credit is, from a legal point of view, equal to the demand guarantee, there are important differences between the two. The standby credit has developed into an all purposes financial support instrument embracing a much wider range of uses than the normal demand guarantee. For this reason, and since the UCP is the most suitable and compatible set of rules with the basic character of the standby credit, the link between the Standby Credit and UCP was maintained.

Before we start interpreting the articles of the ISP98, going through the following hypothetical example on standby LC will help the reader to form an over view of this important financial tool and assist him in understanding its mechanisms. A quick note: in real life cases, the text of Performance Standby LCs normally differs from the following one in that it contains more specifications as to the different phases required to consummate an underlying project.

Example 'Happy Seasons Supermarket' decided to move into larger premises. They chose to construct their own building to suit their specific storing requirements. To do so, they signed an agreement with 'Solid Steel Building Contractors' to construct the desired new building. Amongst other terms, the agreement included the following condition:

'Prior to the commencement of the construction of the building in question, "Solid Steel Building Contractors" must arrange for the issuance of a standby LC for the value of the contract that is USD524,000,000 through a reputable bank allowing "Happy Seasons Supermarket" to draw said value if, and only if, "Solid Steel Building Contractors" fails to deliver the building ready for use on or before 20 April 2010, and/or fails to deliver the building in accordance with the specifications and terms of the signed agreement between them bearing reference JSCS 279 GTI.'

Specifying the terms, 'Solid Steel Building Contractors' instructed their bank 'National Bank of Azaro' to issue a standby LC in favour of 'Happy Seasons Supermarket'. National Bank of Azaro in turn issued the following LC:

Issuer: National Bank of Azaro
Happy Seasons Supermarket
38 floor, Miami Square
Pierre Alberto Place
Yerevan – Armenia
2 March 2025
Dear Sirs,

We hereby issue our irrevocable standby letter of credit No. ANSBC7 by order of Solid Steel Building Contractors Ltd., Rasha Street – Terra Sancta Area, Armenia, for an amount of USD524,000,000 (five million

two hundred forty thousand US Dollars only), which expires at out counter on 20 April 2025.

This credit is available by payment against presentation to us of the following documents:

1. Your sight draft drawn on us (National Bank of Azaro) for the amount of your drawing.
2. Your certificate stating that you have effected payment to Solid Steel Building Contractor Ltd. in accordance with agreement number JSCS 279 GTI and were not delivered the building on 20 April 2025 per said agreement.

Partial drawings not allowed. All charges under this standby letter of credit are for the account of beneficiary.

Except where otherwise expressly stated, this standby letter of credit is subject to the Uniform Customs and Practice for Documentary Credits (2007 Revision) ICC Publication No. 600. Please quote our reference number on any future correspondence.

Yours faithfully,

National Bank of Azaro – Armenia

From this example, we can deduce that Happy Seasons Supermarket were willing to grant their big project to the building contractors only if they received a reliable and legal assurance that the contractor will deliver the building in accordance with the contract. This assurance was in the form of a standby LC by which a reliable bank, National Bank of Azaro in this case, undertook (legally promised) to honour (pay) any claim Happy Seasons make if the contractor fails to deliver what has been agreed upon (default situation).

Note here that the Happy Seasons Supermarket (beneficiary) need not prove that the contractor failed to deliver, all they need to do is to present a simple direct claim and a demand draft, and the two documents are adequate to oblige the issuing bank to honour.

To reiterate, there are vast varieties of other uses for standby LCs. It may be issued by an importer in favour of an exporter to secure the latter's right for payment if funds were not received directly from the importer. It may also be issued in favour of a bank in another country as a form of security for issuing a counter guarantee or a standby LC, or it may be issued as a form of securing a loan granted by a bank to a borrower. A seller can also issue a standby in favour of the buyer.

2.2 LETTERS OF CREDIT AUTHORITIES

The LCs are solely governed by two sets of rules codified by the ICC and distributed amongst banks worldwide: (1) the UCP600 (UCP – 2007

Revision, Publication No. 600) which represent the international standard banking practice for commercial documentary credits, and (2) the ISP98 which represent the international standard banking practice for standby LCs. Throughout this book, our study will be confined to interpreting the ISP98 rules of practice and exploiting the rudiments of practical international banking operations with regards to the infamous standby LC.

The ICC rules of practice collectively address the full scope of issues that are the predicates of the credit transaction, such as the amount payable, validity of the credit and presentation, checking documents, roles and responsibilities, non-documentary conditions … etc.

The UCP600, the most widely used set of rules on a global and national scale, is currently being utilized, to a limited extent, to cover standby LC and sometimes guarantees. It is mainly intended to deal with commercial documentary credits, but literally includes standby LC within the scope of its application. Having said so, it is essential to understand that there are so many articles in the UCP600 that are totally inapplicable to standby LC and letters of guarantees. Nevertheless, applicants frequently incorporate the UCP into these two instruments.

The importance of the UCP, ISP and URDG is that they actually act as laws in countries which have no statutory or case law for LC. Further, in countries with no laws on standby LC and letters of guarantees, a court may look to the UCP600 to resolve a credit dispute, even though it has not been specifically incorporated into the instrument at issue.

'The URDG are the rules specifically inaugurated to apply to independent guarantees, nevertheless, they are also standby LC within their scope. Strangely enough, in reality demand guarantees are occasionally issued subject to the URDG.'

The ISP98 is the second major set of rules adopted by the ICC. It specifically addresses international standby LC; however, it is not limited by its terms to international usage. The ISP98 is 'a set of rules of practice to fill in the gaps where the ICC's UCP, which focuses on commercial LC, has been found not to be fully applicable to standby LC.' It is intended to govern standby LC, but is broad enough that it may also be incorporated into any independent undertaking, including demand guarantees. Let us now move to interpreting each of the rules of the ISP98.

2.2.1 The scope and application of the ISP98

Rule 1.01 of the ISP98

This first provision of the ISP98 indicates the situations in which the rules apply (scope). Although the rules were specifically regulated for all types of standby LCs, they may govern any other similar undertaking, however

named or described, provided of course, an express reference to the rules is made in the text of the undertaking. However, since we are examining the rules from a strictly banking perspective, this book will only discuss their use in situations related to standby LCs.

So Subrule (a) states that the ISP98 is intended to apply to standby LC. Subrule (b) clarifies that application of the rules to any standby letter of credit must be made clear by expressly referring to them in the text of the LC. Subrule (b) also allows subjecting undertakings similar to standby LCs to ISP98 – for example it is possible to issue a bank guarantee subject to ISP98, although demand guarantees have a separate set of official rules (URDG). Such similar undertakings are called 'standbys', hence, there is a difference between a 'standby LC' and a 'standbys'.

Same as in all official DCs (Documentary Credits) rules, it is possible to modify or exclude the application of any provisions in these rules by expressly demanding so in the text of the undertaking, Subrule (c) so states.

Subrule (a) segregated standby LCs into three different types; performance standby LC, financial standby LC and direct pay standby LC. Performance standby LCs are those under which the applicant is required to perform a non-monetary obligation, same as the building contractor in the example above. Conversely the standbys that requires the applicant to pay a financial debt owned are named financial standby LCs.

Direct Pay Standbys are those obligating the issuer to pay principal, interest or both when a financial instrument becomes due or upon redemption. These standbys can also cover a default situation. They are commonly used in issuing financial instruments like treasury bonds and other securities. The default coverage is meant to protect against insolvencies of the issuer of the securities or the debt instrument.

Subrule (b) uses the words 'however named or described' indicating that the name/designation of a standby LC is irrelevant. It is only the nature of the undertaking that determines its function as a standby LC. This rule was initiated to cover situations where terms such as 'Letter of Credit', 'Documentary Letter of Credit', 'Commercial Letter of Credit' or 'guarantee' are used to describe a standby LC, which is common in some places.

2.2.2 ISP98 relationship to law and other Rules

Rule 1.02 of the International Standby Practices (ISP98)

Whilst the ISP98 set of rules only apply whenever it is expressly incorporated into the text of the standby LC, naturally the commercial

law, banking law, LCs law or any other laws are in constant state of prevalence where ever they are instituted by statute or otherwise. This means that the law supersedes the rules of ISP98 and any other LCs rules of practice.

Almost every country has its own commercial and banking laws. Occasionally, these laws contravene the terms and conditions of an LC. In such cases, the provisions of law apply and not the provisions of rules. Let's take an example: A local commercial standby LC (opened subject to ISP98) requires the beneficiary to present to the confirming bank a claim and a copy of an unpaid invoice for payment. The issuer, the confirming bank and the beneficiary are all located in California. The American commercial law states that banks must not accept a copy (or copies) of any document for payment in LCs transactions, that is, the law strictly precludes banks from accepting copies and in all circumstances pertaining to LC transactions.

During the validity of the LC, the beneficiary presented the confirming bank with a claim and a copy of the unpaid invoice demanding payment for the LC's value. The confirming bank checked the documents and decided that they comply with the terms and conditions of the LC and effected payment accordingly. The confirming bank then dispatched the documents to the issuer (who happened to be the reimbursing bank in this case) certifying that the documents were presented in conformity with the credit terms and claiming reimbursement for the amount paid. The issuing bank upon checking the documents spotted the copies presented and treated the presentation as discrepant on the grounds that national laws prohibit acceptance of copies of documents in any LC transaction. The confirming bank was unable to recover the funds from the beneficiary because they paid without recourse.

In this hypothetical case, although the documents presented complied with the LC terms and conditions, the issuing bank had every right to decline reimbursement because the law prohibits acceptance of copies.

Subrule 1.02 (b) applies whenever a standby letter of credit is made subject to more than one set of LCs rules at the same time, for example, in cases where standbys are made subject to UCP and ISP at the same time. It is important to note that the ISP98 provisions supersede conflicting UCP provisions or any other rules only when the LC is deemed to be a standby. This is because the ISP98 are intended to apply to standby undertakings. If a commercial LC, for example, was made subject to ISP98 and UCP600 at the same time, the situation would be different. The ISP98 provisions will not supersede the UCP600 provisions and Subrule 1.02 would not apply to conflicting articles.

2.2.3 Interpretive principles

Rule 1.03 of the ISP98

Same as the UCP, the ISP98 is called 'Rules of Practice'. The term 'Rules of Practice' means that the actions (procedures) undertaken by international banks in handling LC transactions (practice) were gathered and recorded as rules, that is, the UCP600 and ISP98 actually represent what international banks do or almost do whenever they issue or advise an LC, hence, the term 'Rules of Practice'.

The official body that articulated the rules of practice and circulated them amongst banks worldwide is 'The ICC' in Paris. The rules currently receive global recognition.

The ICC has done so for a multitude of reasons, including the need for a globally unified reliable system of payment that guarantees the rights of various businesses involved in international commercial transactions.

We can now conclude that the UCP and ISP are the pillars of a globally used commercial system of payment that *was* evolved by merchants and bankers to meet their needs for reliable and liquid undertakings. Such a system was not instituted by statute or case law, that is, it was not created by lawyers in a distinct legal system and thus its rules should not be interpreted in any context other than commercial practice. What does this mean? It means that the ISP98 must always be interpreted in the context of a reliable and liquid instrument used to avail immediate payment to the beneficiary upon presentation of a simple demand without having to go beyond checking the demand sheet on its face to ensure that it complies with the standby terms and conditions. In other words, banks must not search for excuses in commercial law or any other law to persuade courts to issue orders that allow banks to stop honouring the beneficiary's demand. In fact the essence of the standby LC is to secure payment regardless of disputes. Only in the case of undoubted fraud do the courts allow halting payment under a standby LC.

Subrule 1.03 (b) used the words '*day-to-day transactions*' to illustrate the practical nature of the ISP98 and stress that the rules are intended to be used by practitioners in their daily operations. This implies that interpretations of the rules from a legal perspective would contradict their purpose and may create harmful complications; a matter that contravenes their purpose.

Subrule 1.03 (c): We have explained that the ISP98 is the pillar of an international system of payments. Such system has its own autonomy and does not contradict the international system of correspondent banking. Any interpretation that depicts the rules inconsistent with said system of correspondent banking would be contrary to its purpose.

Subrule 1.03 (d) stressed that the interpretations of the rules must not be based on the individual legal practices of the different countries. There must be world wide uniformity in their interpretations.

2.2.4 Effect of the Rules

Rule 1.04 of the ISP98

Once a standby LC subject to ISP98 is issued, several inter-connected banking commitments (undertakings) may follow: the LC will necessarily have to be advised by a bank in the beneficiary's country, it may ask the advising bank or a third bank to add its confirmation to it, it may be amended or transferred if transferable or it may give rise to any other similar undertaking like acknowledgment of assignment of proceeds. Such post LC issuance undertakings, once taken upon the self of the concerned bank/person, will automatically become subject to the ISP98, unless of course the text excludes or modifies the scope of the ISP98 application. Hence, not only does the ISP98 bind the issuer and that beneficiary who utilises the standby, but also any other person who acts upon an authorization in the standby LC like an advisor, a confirmer, a nominated bank … etc.

Note in Rule 1.04 (vi), the applicant who instructs the bank to issue a standby LC subject to ISP98 is also bound by the rules. If the applicant instructs the bank to issue a standby LC without specifying that such LC must be subject to ISP98 and the bank nevertheless issues the LC subject to ISP98, the applicant would be bound by its rules *only* if it does not object to the incorporation of the ISP98 after receiving the LC issuance notice in due time.

It is worthwhile mentioning here that although the applicant may be bound by ISP98, it is not really a party to the standby LC and can not object if the issuer decided to amend the LC on its own in case the applicant goes insolvent, for example, although this may effect the reimbursement rights of the issuer. Also the applicant has no right to assert discrepant documents directly against any person other than the issuer, like the beneficiary or a nominated bank.

2.2.5 Due issuance and fraudulent or abusive drawing

Rule 1.05 of the ISP98

The rule stresses that handling problems pertaining to due issuance of a standby must be left to the applicable law. What does this mean? Let's read

the following example:

Bank Azaro has issued a standby LC based on instructions signed by a customer's staff who was not an authorized signatory, that is, the bank made a mistake when they accepted his signature on the application form. Upon presentation of compliant documents by the beneficiary, the bank refused to honour because the LC was erroneously issued. In such a situation, the beneficiary can not resolve this problem by referring to the ISP98; this problem can only be resolved by the Law which governs the rules of the ISP98 (also refer to Rule 1.02). Of course there are many other reasons that could render the issuance of an LC erroneous.

Note here that the beneficiary need not worry about whether the bank has duly issued an LC if it appears to be issued in the normal course of business. Once a bank issues such an LC, it definitely and irrevocably undertakes to honour its value upon presentation of compliant documents. It also bears the responsibility of its wrongful acts; undue issuance is an example of a wrongful act.

Subrule 1.05 (b) states that the ISP98 does not dictate upon issuers what formalities are needed to make a standby valid, that is, the rules do not oblige banks to sign, stamp, mark, … etc. the standby instrument. It is however, a standard market practice that any standby LC issued by a bank, including an electronic standby LC, must be signed or authenticated in any other way (key number, symbol, electronic signature … etc.) and must be presented in a tangible form. Furthermore, many statutes dictate that an LC, however presented, must always be signed or otherwise authenticated in an acceptable manner.

Subrule 1.05 (c) reiterates that an issuer's obligation to pay is definite and the issuer can halt payment only upon obtaining a court injunction. According to the independence principle, courts will not grant such an injunction unless there is a case of clear and indisputable fraud.

2.2.6 Nature of standbys

Rule 1.06 of the ISP98

Subrule 1.06 (a) states that a standby LC subject to the ISP98 is:

i. Irrevocable: Once a standby LC is issued, it will remain valid and enforceable until it expires, regardless of whether or not the beneficiary draws on it. The Bank that issues a standby LC is always bound to honour its value upon presentation of conforming documents within the LC validity, that is, the issuer can not cancel the standby LC after issuance

(can not revoke its undertaking). The rules of ISP98 do not provide for the issuance of revocable standby LCs.

ii. Independent: This principle means that payment under a standby LC is totally dependent on the presentation of compliant documents; neither the underlying contract from which the standby LC was originated, nor the actual performance/default of the applicant, nor the relationships between the beneficiary and applicant or other relationships matter. The issuer must determine whether payment is due or not solely by examining the documents presented on their face against the terms and conditions of the standby LC.

iii. Documentary: This principle dictates that every condition in a standby LC should require the presentation of a document to evidence compliance therewith. The rule emphasizes the documentary nature of standby LCs. Rule 4.11 also stresses the necessity to stipulate the presentation of documents by obliging banks to disregard non-documentary conditions.

iv. Binding: We explained earlier that the issuer is under a duty to honour a conforming presentation once made regardless of whether or not it has duly issued the Standby LC, and it was clarified that the beneficiary need not worry about whether the bank has duly issued an LC if it appears to be issued in the normal course of business. Once a bank issues such an LC, it definitely and irrevocably undertakes to honour its value upon presentation of compliant documents. The issuer bears the responsibility of its wrongful acts; undue issuance is an example of a wrongful act. Even if the issuing bank – in trying to prove that it is not obliged to honour a compliant presentation made under an unduly issued standby LC – claims that it did not receive adequate consideration (take fees, charges or receive any other benefit) for issuing the LC, the issuing bank will remain responsible for the issuance of the LC and will bear the consequences thereafter.

It is *not* obligatory to indicate in the text of the standby LC that it is irrevocable, independent, documentary and binding. This rule provides that it is so once issued and it does not need to state so.

Subrule (b): Here it is stressed that once a standby is issued, it can not be amended nor cancelled without the consent of all parties concerned, that is, the issuer and the person effected, normally the beneficiary. It is, however, possible to amend the LC automatically if it contains specific stipulations to that effect in the text of the LC itself, for example, amendments with regards to the amount or duration.

Let's move to Subrule (c). Here again the independence principle is clarified. The rule emphasizes the issuer's obligation to honour a compliant

presentation under all circumstances and regardless of whether or not:

i. they can obtain reimbursement from applicant, if for example the applicant goes insolvent;

ii. the beneficiary has a right to obtain payment directly from the applicant;

iii. the standby LC refers to the underlying agreement or reimbursement agreement;

or

iv. the issuer is aware that a party has either performed, defaulted or breached any reimbursement agreement or underlying transaction. This is normal since the issuing banks are not qualified to determine the accuracy of claims or accusations against the beneficiary.

In Subrule (d), it is reiterated that the standby LC is a documentary undertaking, and payment is dependent on examining a presentation made under the standby LC to determine whether the documents presented appear on their face to comply with the terms and conditions of the LC. *Appear on their face* is a term that confines the banks' duty to only checking the physical documents presented, and it does so in a certain way peculiar to bankers; banks just do not go beyond that.

In Subrule (c), it is clearly reiterated that the issuer is always bound (except in the case of a clear and undoubted fraud) to honour a complying presentation made under a standby LC whether or not the applicant authorized its issuance, the issuer received a fee, or the beneficiary received or relied on the standby or amendment.

2.2.7 Independence of the issuer – beneficiary relationship

Rule 1.07 of the ISP98

This rule, as indicated by its title, embodies the Doctrine of Independence; it is an illustration of the previous rule. It simply says once the issuing bank issues a standby LC, it is bound to honour the beneficiary's claim under such LC provided the claim is presented, together with other stipulated documents if any, in full compliance with the terms and conditions of the standby LC. The issuing bank's responsibility does not exceed checking the set of documents presented on its face and in accordance with the provisions

of the ISP98 to ascertain whether or not these documents comply with the LC terms. If said documents are found to be compliant, then the issuer can not halt (stop) payment because:

a. The applicant can not or does not want to reimburse the issuer as in the case of the applicant's insolvency, for example.

b. The issuer did not receive the consideration previously agreed upon with the applicant in return for issuing the LC. (Consideration under the Law of Contract in the United States of America and England is a legal term meaning the benefits, in commercial relationships and not social ones, which must be obtained by the seller of a product or service to render a contract valid. Consideration here means the issuance fees/charges, handling charges, payment charges, negotiation charges, acceptance charges, confirmation charges or any other benefit the issuing bank receives for issuing the LC). So if the issuer did not receive any charges or benefits after it has issued the LC, it can not halt (stop) payment by claiming that its contract with the applicant is void for inadequate consideration.

c. Of claims by the applicant that the beneficiary's presentation is fraudulent.

d. Of claims related to the underlying agreement (contract from which the LC was originated) or reimbursement agreement even if such contract and agreement were referred to in the text of the standby LC.

e. Any other reason whatsoever. A standby LC once issued is irrevocable, independent, documentary and binding undertaking and payment under it can not be stopped except by a court injunction in a case of clear and undoubted fraud.

2.2.8 Limits to responsibilities

Rule 1.08 of ISP98

Subrule (a) indicates that the issuer does not bear any responsibility whatsoever upon honouring a false/fraudulent claim presented by the beneficiary in compliance with the standby LC terms and conditions and the ISP98 provisions. In such cases the issuer is entitled to reimbursement from the applicant, unless of course the issuer does possess an undisputed evidence that the claim is a fraudulent one. It follows that even if the issuer doubts the integrity of the compliant presentation without clear evidence supporting its doubts, it still can not halt payment; Here, the applicant can look for remedy in criminal law.

Subrule (b) states the issuer does not bear any responsibility for the genuineness of any document presented under the LC. It is merely responsible

for checking the documents on its face to ascertain whether they comply with the LC terms and conditions or not. Again, even if the issuer honours a claim presented with fraudulent or forged documents, it will still remain entitled to reimbursement by the applicant unless it had a clear evidence that the presentation was a fraudulent one.

Subrule (c) indicates that the action or omission (negligence) of the nominated person is not the responsibility of the issuer. By nominating another bank, the issuer authorizes such bank to pay, undertake a deferred payment obligation, accept drafts or negotiate the documents presented in compliance with the LC terms and ISP98 provisions. Hence any action taken by the nominated bank or any negligence to perform a certain duty by such nominated bank will not be the responsibility of the issuer. The nominated bank can only bind the issuer for acts within the scope of the issuer's nomination. So if the nominated bank which accepted its nomination and so advised the beneficiary, negligently honoured documents that were presented after the dates allowed for presentation, then the issuer will not be responsible to reimburse the nominated bank for the discrepant set of documents presented.

Now let's imagine this situation; A beneficiary presented documents to the correspondent bank ten days before the LC expires. The correspondent bank was acting merely as an advising bank and negligently dispatched the documents by courier to the issuer after 11 days from receiving it, that is, after the expiry date of the LC. The issuer received the documents, found that they contained an 'LC expired' discrepancy and therefore rejected the documents. As the beneficiary presented compliant documents well within the LC validity, the beneficiary refused to assert the discrepancy and demanded immediate payment. In such cases, the issuer under this rule will not bear the responsibility of the correspondent or nominated bank's negligence even though the issuer chose such bank to advise the credit. The applicant bears the risk here. If the applicant wishes to choose the correspondent bank itself, it may ask the issuer to do so. The issuer has the right to accept or reject such a choice.

In Subrule (d) too the applicant bears the risk of observing laws applicable other than the laws at the issuer's country or the law specified in the text of the standby LC. This is not the responsibility of the issuer.

2.2.9 Defined terms

Rule 1.09 of ISP98

Subrule 1.09 (a) defines the following terms:

Applicant is the person who fills out and legitimately signs the standby LC application form (notice that since we are interpreting the ISP98 from a

banking operations perspective, we will continue to use the term 'Standby LCs' instead of the term 'standby' which describes any undertaking subject to ISP98).

The term 'Applicant' also includes: (1) a person who applies in its own name for the account of another person or (2) an issuer acting for its own account. Here, the rule provided for circumstances under which an applicant opens an LC for the account of another person and places the name of this other person in the text of the operative LC instrument (SWIFT/MAIL/Electronic Message) as applicant. In such situations, the term 'Applicant' includes both the person listed on the face of the LC and the person who authorized the LC issuance. A parent company, for example, may authorize a bank to issue a standby LC for the account of a subsidiary. The subsidiary's name will appear on the face of the LC but both of them would be described as applicants.

The term 'Applicant' also describes an issuer who issues a standby LC on its own behalf.

Beneficiary is the named person eligible for payment against the presentation of compliant document(s) stipulated by the standby LC. The beneficiary is also the person to whom the original beneficiary named in the standby LC has effectively transferred drawing rights (***Transferee Beneficiary*** per Subrule 1.11 (c) (ii)).

Business Day is a day on which the place of business is regularly open for documents presentation, issuance, confirmation or any other activity pertained to the LC.

Banking Day is a day on which the specific bank required to perform a certain duty in the LC transaction is regularly open for business.

Confirmer is the bank that, upon the request of the issuer, adds to the issuer's irrevocable undertaking its own irrevocable undertaking to honour the value of documents presented in compliance with the credit terms and conditions. Thus, under a confirmed LC, there are two irrevocable undertakings to honour (pay/undertake to pay) the value of documents presented in compliance with the LC's terms and conditions.

Demand means a written request signed by the beneficiary and presented to either the issuing or confirming bank demanding payment as per the standby LC stipulations (full value, partial value, … etc.). The demand may be a Demand Draft drawn on the issuer/confirmer, a written request on a normal paper, electronic documents or any other form of document required by the standby and serves to demand payment under same standby.

Document in order for any document to be accepted upon presentation to the concerned bank (issuing bank, paying/accepting/negotiating bank or

confirming bank), it must be capable of being examined for compliance with the terms and conditions of the Standby LC.

Drawing means a document or a set of documents presented to the concerned bank requesting payment under a standby LC. It could also mean an honoured demand (as if the *Drawing* was paid by the confirming bank).

Expiration Date means the latest date allowed for presentation of documents under a specific standby LC. If documents are not presented on or before the expiration date, all obligations of the issuer, the paying/accepting/negotiating bank or the confirming bank will become void as documents will be discrepant.

The Standby LC may stipulate a specific date for presentation of documents that comes earlier than the Expiration Date as in the case of a standby LC which allows partial drawings within specific periods of time.

Person in many places, a standby can be issued by any person whether natural or otherwise like a bank, partnership, corporation … etc. This is the reason for using the word 'person' instead of bank as in the UCP600.

Presentation Delivering documents for examination under the standby. It can also be used to describe the act of delivering documents as in the case of presenting documents to an advising bank that is merely responsible for dispatching such documents to the issuer or confirmer without any responsibility.

Presenter is the person who makes the presentation, normally the beneficiary or some one else on his behalf.

Signature includes any symbol placed on the document for the purpose of authenticating it.

Subrule (b) state the cross references to be read in conjunction with the definitions stated above.

Subrule (c) defines the following terms used in Electronic Presentations:

Electronic Record in documents presented electronically is the same as the paper documents in the traditional presentation made under a standby LC. For an electronic record to be acceptable by the receiving parties, it must be written (inscribed) on a tangible medium or stored in electronic or other medium and is capable of being retrieved in a perceivable form, for example, a copy of an invoice attached to an email and sent to a receiver, when printed is retrieved in a perceivable form. A record must be generated electronically and sent to a system for any kind of processing action. Most

importantly, it must be possible to authenticate and examine the record for compliance.

Authentication means identifying the sender or the source and the integrity of the transmission. This partly means to ascertain whether the data sent originally has remained unaltered and complete.

Electronic Signature An electronic signature is any symbol or mark used for the intent of authenticating an electronic record.

The Electronic Signatures in Global and National Commerce Act or E-SIGN in the US was adopted to make a transaction's electronic contract and signatures legally binding, hence reflecting the importance of e-commerce and the anticipation of rapid growth in the number of electronic transactions. It was said that the e-signature gives legal teeth to contracts with electronic transaction records and signatures. An electronic signature, according to E-SIGN, is any electronic sound, symbol or process in a counteract or other record that a person uses as his or her signature. It can be as simple as the 'I Agree' button on a Web form or as complex as a digitalized signature, fingerprint or retinal scan embedded into a document. Logically, the greater the perceived commercial, financial and/or legal risks, the more complex the e-signature on the transaction in question will be. The risk of a digital contract not acknowledged by a court of law or being a fraudulent or an abusive one is substantial, especially for transactions of high values. A commercial letter of credit for an oil transaction of $20 million, for instance, would be a prime target for litigation. Albeit E-SIGN legally equates traditional paper signatures with electronic contracts, it also imposes an additional burden on electronic versions. Organizations must get the consent of their customers to opt in and use electronic records. In banking this is automatically done within a letter of indemnification that the customer has to sign upon applying to use the bank's Front-End Electronic System.

Receipt occurs when the electronic record enters in a form capable of being processed by the designated system in the standby, or when the issuer retrieves an electronic record sent to a system other than that designated in the standby.

Subrule (b) highlights the cross references in the ISP as follows:

'Amendment' – Rule 2.06
'Advice' – Rule 2.05
'Approximately' ('About' or 'Circa') – Rule 3.08 (f)
'Assignment of Proceeds' – Rule 6.06
'Automatic Amendment' – Rule 2.06 (a)
'Copy' – Rule 4.15 (d)
'Cover Instruction' – Rule 5.08

'Honour' – Rule 2.01
'Issuer' – Rule 2.01
'Multiple Presentations' – Rule 3.08 (b)
'Nominated Person' – Rule 2.04
'Non-Documentary Conditions' – Rule 4.11
'Original' – Rule 4.15 (b) and (c)
'Partial Drawings' – Rule 3.08 (a)
'Standby' – Rule 1.01 (d)
'Transfer' – Rule 6.01
'Transferee Beneficiary' – Rule 1.11 (c) (ii)
'Transfer by Operation of Law' – Rule 6.11

2.2.10 Independence of the issuer – beneficiary relationship

Rule 1.10 of the ISP98

By explicitly stating that they should not be included in the text of a standby LC, Subrule 1.10 (a) discourages the use of the terms unconditional, abstract, absolute, primary, payable from the issuer's own funds, clean or payable on demand. If, however, any of these terms was used, it shall be construed in the following manner:

i. Unconditional or Abstract: The documentary credit by nature can not be unconditional since payment under it is conditioned upon presentation of documents that conform to the LC terms and conditions (Rules 1.06 and 4.11). Hence the term Unconditional or Abstract when in use will mean that the LC undertaking is conditional to ONLY one term that is presentation of compliant documents.

ii. Absolute: Rule 1.06 (b) states that the standby LC is irrevocable, meaning that the beneficiary can present documents any time within the LC validity and must obtain payment if such documents complied with the LC terms and conditions. Hence whenever the term Absolute is used in a standby, it will only mean that the standby is irrevocable.

iii. Primary: Rules 1.06 and 1.07 illustrated the independent nature of the standby LC. And since the word Primary whenever used in a standby LC text generally means that the obligation under the standby LC is independent of the underlying transaction, it will always be so interpreted.

iv. Payable from the issuer's own funds: Some beneficiaries demand the inclusion of such term as means of assurance for payment in case the applicant goes insolvent. Subrule 1.06 (c) (i) clearly states that it is the

issuer who must honour the compliant presentation regardless of its ability to obtain reimbursement from the applicant. Hence, there is no need for the use of this term but if used it will only bear the meaning of Rule 1.06 regarding the issuer's definite responsibility for payment of compliant presentations.

v. Clean: Because it is normal to see so many standby LCs issued payable against a simple claim presented by the beneficiary; many areas use the term Clean in relation to standby LCs as opposed to commercial LCs. Clean is also a technical term used to describe a special type of LC that requires the presentation of only one document, specifically a demand draft, for payment under the LC. Because of this duality in meaning that could cause confusion in cases where the term Clean is used, Subrule 1.10 (v) of the ISP98 provided whenever this term is used it means that the LC is payable either upon presentation of a simple claim or the full set of documents stipulated in the LC.

vi. Payable on Demand: Rule 2.01 of the ISP98 sets forth the responsibilities of the issuer to pay. Using the term Payable on Demand does not alter such responsibilities. Therefore, Subrule (a) (v) states that if this term is used, it will only mean the issuer is obliged to honour a presentation if presented in compliance with the LC terms and conditions.

Subrule (b). And/or: a standby should not use the phrase 'and/or'. If it does, the phrase will mean either or both options.

Subrule (c) (i) states that the following terms if included in the text of the standby LC shall be disregarded: 'callable', 'divisible', 'fractionable', 'indivisible' and 'transmissible'.

Subrule (c) (ii) states that the terms Assignable, Evergreen, Reinstate, Revolving need not be disregarded if the contexts in which they are incorporated have a clear meaning. These terms are common in LCs operations; Assignable sometimes used to define the right of the beneficiary to assign the LC proceed in part or in whole to a third party.

Evergreen is a special type of LCs that can be renewed automatically for long periods and normally used by reinsurance companies. Reinstate is used when the LC is to be renewed automatically. Revolving is that type of LC that can also be renewed automatically.

2.2.11 Interpretation of the Rules

Rule 1.11 of the ISP98

Subrule (a) provides for situations where an ISP98 rule is interpreted in two different meanings, one of which reflects standard banking practice whilst the

other does not. The interpretation based on banking practice should be the determinative one.

We have previously explained that the ISP98 represents the actions normally taken by international banks when they advise or issue a standby LC. Hence, the rules of the ISP98 represent standard banking practice; it is for this reason that these rules should always be interpreted in the context of practical banking and must not be theoretical.

Let's move to Subrule (b) which illustrates the difference between the terms 'Standby LC' and 'standby'. A 'standby' is any undertaking subject to ISP98. Whenever this term is used in any rule, it should be clear that the undertaking intended by the rule is not necessarily a Standby LC although it could be.

A 'Standby LC' is a special type of LCs that encompasses a wide range of uses. Although the standby LC normally covers default situations, it may be used, and is used, in performance situations, commercial transactions and direct pay commitments. Nevertheless, it is described as a letter of credit which is not a commercial letter of credit to distinguish it from the conventional commercial LCs that require the presentation of conforming documents to prove the performance of a specific duty by the beneficiary (often the shipment of goods); such presentation of compliant documents is a prerequisite to initiating payment under the LC.

Whenever the term Standby Letter of Credit is used, it only refers to standby LCs and not to other standby undertakings. For example, in Rule 1.02 (b) it was stated that if a standby LC was made subject to another set of rules in addition to ISP98, the ISP98 rules will prevail over the other rules in case of conflict. This subrule applies only to Standby LCs and not to other types of undertaking that are subject to the ISP98.

Subrule (c) provides that unless otherwise stated in the text of the standby LC, the 'Issuer' means either the actual issuer or the confirmer. The rule here treated the confirmer as a separate issuer and its confirmation a separate standby issued for the account of the issuer. This is to avoid repetition of the word 'and confirmer' every time the word issuer was used, and also to emphasize the identical responsibilities of both the issuer and confirmer. Having said so, it is important to note that the two words had been distinguished from each other in Rule 3.04 (Where and to Whom Complying Presentation Made).

The 'Beneficiary' is the person allowed to draw on the standby and this term includes a transferee beneficiary or a multiple successive transferee beneficiaries.

'Including/included/includes' whenever used indicates that the situation in question is not exclusive.

'A or B' means A, B or both A and B.

'Either A or B' means A separately, B separately but not both A and B.

'A and B' means both A and B and not just one of them.

'Gender/Plural' Words in the singular includes plural and vise versa. The ISP is gender-neutral; it uses the generic term 'it' for 'him', 'her' and 'it' and their variations. Subrule 1.11 (d) (i) states that it is possible to modify or exclude the application of the ISP provisions by expressly stating so in the text of the standby LC. Thus, the text of the standby supersedes the rules of the ISP98.

Even if one provision of a rule is modified by an addition or change, the remaining provisions of the rule will stay unchanged.

Absence of the phrase 'Unless otherwise stated in the LC' or phrases of similar meanings does not imply that the other rules have priority over the text of the standby.

'Expressly' or 'Clearly' when added to the phrase 'unless a standby otherwise states' it dictates that any attempt to modify or exclude must be specific and unambiguous.

Subrule (d) (iv) provides that the effect of varying some rules may turn the standby into a non independent undertaking under applicable rules of law. For example ISP98 Rule 4.11 could theoretically be excluded. If a standby that did not exclude it contained non-documentary conditions of serious nature, it is likely that the undertaking would be regarded by a court as being a non independent undertaking with a different legal character than a standby LC.

Subrule (e) clarifies that the phrase 'stated in the standby' refers to the text of the standby LC whereas 'provided in the standby' means a provision resulting from application of ISP98 to the standby.

CHAPTER 3

Obligations

3.1 THE UNDERTAKING TO HONOUR BY THE ISSUERS AND ANY CONFIRMERS

Rule 2.01 of the ISP98

Subrule (a) states that the issuer's responsibility is to honour the value of the documents stipulated by the LC provided that these documents are presented in full compliance with the credit stipulations and in accordance with the ISP98 rules supplemented by standard standby practice.

Upon issuing the standby, the issuer irrevocably undertakes a contingent liability, that is, a promise to pay, or an undertaking to pay on due date, the value of the documents required in the text of the LC under the condition that these documents must conform to the standby stipulations and abide with the ISP98 rules.

It is worthwhile noting here that this subrule emphasizes the documentary nature of the standby which was previously explained in Rule 1.06; an issuer is only obliged to check the documents on their face against the standby terms and conditions to determine compliance and is not required to go beyond the face of the documents to ascertain the facts it represents. To clarify, if a beneficiary presented a forged invoice stipulated by the standby, and the issuer could not recognize the forgery because the invoice appeared to be a genuine one, then the issuer bears no responsibility for honouring the value of the fraudulent presentation made; the issuer is not responsible to check and detect the genuineness of the documents beyond what it appears to be.

Subrule (a) uses the phrase supplemented by standard standby practice. This means that whenever a standby rule is not clear, incomplete or

outmoded it should be interpreted and supplemented by reference to standard standby practice.

Before discussing Subrule (b), let us first go through the different types of standby LCs:

1. LCs available by Sight Payment: The beneficiary under this type of LC is entitled to payment of conforming documents within: (i) a maximum period of seven banking days following the day of delivering the documents (presentation) to the concerned bank in the case of commercial credits, or (ii) the time limits set in Rule 5.01 in the standby LC or undertaking.
2. LCs available by Deferred Payment: This is the type of LCs under which the exporter (beneficiary) agrees to allow the importer a usance period for settlement. The concerned bank here undertakes to pay the value of the compliant documents at a future determinable or fixed date.
3. LCs available by Acceptance: The presentation of documents here must be accompanied by a draft which will be accepted by the concerned bank if documents are presented in conformity with the LC terms.
4. LCs available by negotiation: According to UCP600 Article 2, negotiation means the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank. Under negotiation the negotiating bank purchase documents by paying at sight or undertaking to pay at a future date with or without recourse depending on the agreement with the beneficiary. The confirming bank negotiates without recourse at all times if the credit is available by negotiation with the confirming bank.

Now let's go back to Subrule (b): if the standby is available at sight payment, the issuer becomes obliged to honour the value of compliant documents presented under the LC at sight, that is, within the times allowed by Rule 5.01 to examine the documents and determine compliance. To reiterate, the issuer must determine compliance solely by checking the documents on their face against the standby stipulations and ISP98 rules.

If the standby is available by acceptance of a draft drawn on the issuer, the issuer undertakes to accept the draft if presented in accordance with the LC stipulations and also undertakes to pay its value to the bona fide holder (holder in due course/legitimate holder) on or after its due date.

If the standby is available by deferred payment, the issuer undertakes to honour on the due date the value of documents presented in compliance

with the credit terms and conditions and pay on the maturity date such value.

While this rule does not expressly require the issuer to declare that it has incurred a deferred payment obligation, Rule 5.03 (b) states that failure to give a timely notice of dishonour, precludes the issuer from claiming that the presentation was not in conformity with the credit terms and conditions and thus obligates it to pay on maturity the value of such presentation.

Available by Negotiation: *Negotiation means the purchase of documents. There are two types of negotiation; (A) Negotiation at sight, and (B) Negotiation at deferred payment. The presentation of documents under a standby LC available by negotiation may be with or without a draft depending on the stipulations of the standby.*

If the standby provides for honour by negotiation, the issuer becomes obliged to pay the value of the compliant presentation at sight *without recourse*. Let's take an example; a presentation was made to the issuing bank under a Standby LC subject to ISP98 available by negotiation at sight. The issuing bank examined the documents, determined that they complied with the standby LC terms and conditions and thereafter paid the beneficiary.

Upon submitting the documents to the applicant, the applicant spotted a late presentation discrepancy and objected timely to the issuer on its wrongful honour. The issuer has already paid the beneficiary but now can not recover the money paid because payment under a standby LC available by negotiation at sight is made without recourse, unless of course the standby LC text states otherwise. Since the applicant acted in timely manner in advising the discrepancy to the issuer, the issuer bears the full responsibility.

In cases where the standby LC is available by negotiation at a deferred future date, the issuer undertakes to pay the value of the compliant presentation on the due date. Here the issuer's undertaking may be with recourse and could also be without recourse depending on the agreement between the issuer and beneficiary; of course the text of the standby LC must state whether the negotiation of the deferred value standby LC is with or without recourse.

Subrule (c) introduces the notion 'timely manner' to emphasize that the issuer who pays a sight draft, accepts a draft or undertakes a deferred payment obligation (or if it gives notice of dishonour) must act within the time boundaries introduced in Rule 5.01.

Subrule (d) (i) states that the responsibilities of the confirmer are consistent to those of the issuer which we have just explained in the previous part. One would deduce from the wording of this subrule that the confirmer may undertake to pay a standby available by negotiation on deferred payment basis with or without recourse depending on the text of the standby since this is consistent with the responsibilities of the issuer as per the provisions of

Subrule (d) (i). However, if the presentation under this type of LCs contains a draft, the drawee of the draft may reverse this rule and it could then become the responsibility of the confirmer to incur a deferred payment undertaking without recourse.

To reiterate, *when the draft is drawn on the issuer*, a confirmer honours by purchasing the documents, by paying a sight draft, or undertaking to pay a time draft *WITHOUT ANY RIGHT OF RECOURSE* on the documents or on the draft against the beneficiary or a nominated person who acting upon its nomination has paid. Now this may not be consistent with the undertaking of the issuer whose obligations are indicated by Subrule (b) (iii) only in the case where the credit is available by negotiation at sight but not if the credit is available by negotiation at deferred payment. Do you see the difference here?

To avoid the complexity of interpretation of the rules, banks normally agree with the beneficiary as to whether payment will be made with recourse or without recourse. Such agreement is included in clear wording in the terms and conditions of the credit advice delivered by the concerned bank to the beneficiary.

Subrule (d) (ii) states that if the confirmation permits presentation to the issuer, and the issuer upon receiving the complying documents in a timely manner rejected the documents without good reasons (wrongful dishonour), the confirmer becomes obliged to honour the presentation as if it had been made to it.

In simpler words, the rule allowed the beneficiary to bypass the confirmer and present the documents directly to the issuer only in the situation where the confirmation contains a paragraph that explicitly allows such a presentation directly to the issuer. In all other cases, the confirmer's undertaking ceases to become effective whenever the beneficiary omits the presentation of documents to the confirmer within the periods allowed for presentation in the LC and ISP98. To emphasize, Subrule (d) (ii) states that whenever the confirmation allows presentation to the issuer, and the issuer rejects a complying presentation under same standby wrongfully, the confirmer becomes obliged to honour the presentation as if it had been made to the confirmer itself.

Subrule (d) (iii) states that whenever a timely complying presentation is made to the confirmer under a standby which permits presentation to the confirmer, and the confirmer refuses to honour its value without valid reasons, then the beneficiary can present same documents to the issuer who is obliged to honour the value of such presentation as if it had been made to it since the confirmer's rejection was baseless (wrongful dishonour).

Subrule (e) states that payment must be made with immediate value and in the currency of the standby unless the standby states that payment is designated in another currency or other items of value in which case payment must be made in such currency or such items of value.

3.1.1 Silent confirmation

This term is not included in the ISP98 rules. Rather, it is used to describe a private arrangement between the bank and the beneficiary by which the bank confirms the credit, without the authorization or request of the issuer, on its own risk and responsibility. This is a rare practice which banks undertake to serve one of their important customers.

The major risk of the silent confirmation stems from the fact that the confirmer does not have a relationship with the issuer that allows honour upon the latter's request. The danger of silent confirmation can best be illustrated by the following example:

An advising bank has added a silent confirmation to a standby LC. The beneficiary presented a set of compliant documents. The advising bank checked the documents and decided that they complied with the credit terms and conditions and thereafter effected payment to the beneficiary. Upon dispatching the documents to the issuer, the issuer *wrongfully* dishonoured the documents. The danger here is that the advising bank will not be able to sue the issuer since it has paid on its own responsibility without the issuer's request. The advising bank has no capacity to sue the issuer. To overcome this obstacle, the beneficiary may agree to assign all of its rights under the credit to the advising bank so it becomes eligible to sue under the credit.

3.2 OBLIGATION OF DIFFERENT BRANCHES

Rule 2.02 of the ISP98

This rule corresponds to the sixth paragraph of Article 3 of the UCP600 which considers the branch of a bank in a different country another bank. The difference here is that any branch of the issuer (or agency or other office), whether located in a different country or the same country of the issuer, is considered a separate bank (entity) and is obligated in the capacity in which it acts. Hence, the person's role in the transaction – and not its legal bond with the issuer – is the determinative factor vital to delineate the person's obligation under such transaction.

3.3 CONDITIONS TO ISSUANCE

Rule 2.03 of the ISP98

According to this rule, the bank irrevocably issues the standby once the Society for Worldwide Interbank Financial Telecommunication (SWIFT) message or

the cable is released in the case of issuance by telecommunication or once the signed standby form is dispatched by mail and can not be brought back any more. In other words once the standby leaves the control of the issuer, it becomes an irrevocable binding instrument unless the standby states otherwise.

Some standbys contain terms that require the presentation of a certain document or the performance of a certain action to render the standby 'valid', 'operative' or 'effective'. These terms must be performed like any other terms in the standby unless of course they are non-documentary conditions at which case they must be disregarded per Rule 4.11 (Non-documentary conditions).

Sometimes a standby may contain a term that makes payment subject to (conditional on) the presentation of a document on which the beneficiary has no control. Such conditions make the standby *Inoperative* and usually get incorporated by the applicant to keep control of payment. An example of such documents is a demand under a standby signed by the beneficiary and *countersigned by the applicant.*

Such terms could be to restrict payment within a certain period or at fixed dates (e.g., drawing not available until 20 April 2008).

If the standby contains a condition that it is not issued or enforceable until a certain condition is fulfilled, such a condition must be adhered to and can only be disregarded if it is non-documentary. The standby here is considered a valid, binding and irrevocable instrument from the time of issuance. It is worthwhile noting that these conditions must (repeat MUST) be clearly stated by undoubted wordings like 'unissued and unenforceable until …'.

3.4 NOMINATION

Rule 2.04 of the ISP98

Subrule 2.04 (a): The beneficiary often demands that the value of the standby be paid directly in its country of domicile. To accommodate this requirement, the issuer authorizes a bank in the beneficiary's country, either the advising bank or a third bank, to pay (at sight or another future date) to the beneficiary the value of compliant documents presented under the standby after which the issuer will reimburse such bank for the value paid. The process of authorizing the advising bank or another bank to pay the value of compliant documents is called *Nomination*. In simpler words, nominating a bank in a standby to honour the presentation means authorizing such a bank to directly pay against documents presented in compliance with the terms of the LC and in adherence to the provisions of the ISP98.

The standby may also be made *Freely Negotiable*, this means that any bank is authorized to pay the value of documents.

Field 41a in SWIFT message MT700 used for issuing commercial LCs, shows the wordings 'available with'. This particular field represents the nomination of the bank authorized to pay against compliant documents.

In summary, nomination means that the issuer *asks* the advising bank or a third bank to either advise the standby, receive a presentation, effect a transfer, confirm, pay, negotiate, incur a deferred payment obligation, or accept a draft. Notice here the word *asks*; nomination by the issuer implies that the issuer requests a specific bank to do a specific task, that is, this specific bank is not obliged to perform this specific task; it may accept to perform or it may not. This is what Subrule 2.04 (b) states.

When the issuer nominates another person to perform a certain duty, the former merely requests the latter to perform. Thus the nominated person is in no way obliged to perform the tasks asked by the issuer; it has the right to accept the nomination and act accordingly or it can simply ignore the nomination. If the nominated person elects to accept the nomination of the issuer, it becomes obliged to act to the extent it undertakes to do so. Hence, if the nominated person accepts its nomination, it must also undertake to act in accordance with the nomination so that its acts become legitimate.

It is worthwhile noting here that the term 'Negotiate' used in Rule 2.04 (a) has many meanings in LCs practice; it could mean 'to pay', 'to honour', 'to present documents', 'to examine documents', or 'to forward documents to the issuer'.

Subrule 2.04 (c) provides that a nominated person can not bind the issuer who made the nomination. So if, for example, the nominated bank accepted documents presented under an LC and certified to the issuer that such documents are compliant, the issuer still has the right to examine the documents again to ascertain its conformity with the standby terms and conditions.

3.5 ADVICE OF STANDBY OR AMENDMENT

Rule 2.05 of the ISP98

Read now Subrule 2.05 (a).

In the previous rule, it was shown that the advisor only advises the standby if it elects to do so, that is, it is not obliged to advise a standby upon the request (nomination) of the issuer; it may accept or decline such nomination. If, however, it elected to advise the credit, it becomes under a duty to check the *Apparent Authenticity* of the standby. This means that the advisor must do the following:

1. Check that the SWIFT message contains the words *Message Authenticated*, or similar words, on the header of the message if the standby is transmitted by SWIFT.

2. Check that the test key is correct if the standby is transmitted by telex.
3. Verify the signatures if the standby is sent by mail.

The use of the word APPARENT intended to stress that checking the authenticity of the standby is to be done in accordance with the international standard banking practice. Hence, it is inadequate to authenticate the test key of a standby received by telex without evidencing this by marking the file copy with words proving the test key was authenticated.

In addition to the above, the international standard banking practice dictates that the advisor must check its black lists, internal guidelines, management circulations and governing regulations to determine whether the standby can be advised or not.

Subrule 2.05 (a) (ii) of the ISP98: Suppose the advisor received the standby by SWIFT and accepted to advise it to the beneficiary without any responsibility on its part. And whilst the advisor was recording the standby into its own electronic system, it mistakenly keyed in wrong terms and conditions, that is, instead of stating the expiration date 9 June 2007 it stated 9 July 2007. Here the advisor bears the full responsibility if the beneficiary, acting on the advice without noting the attached original standby, made a late presentation. This is because the advisor under this rule has a duty to provide the beneficiary with an advice that accurately reflects what was received; it must avoid negligence.

Another example would be forwarding to the beneficiary a printout of a standby received in full but printed missing some lines due to a computer malfunction. The advisor here also assumes the responsibility for it failed to provide the beneficiary with an advice that accurately reflects what has been received.

Subrule (b) states that if the person nominated by the issuer to advise a standby does not want to do so, it *should* notify the issuer that it will not advise the standby.

3.6 WHEN AN AMENDMENT IS AUTHORIZED AND BINDING

Rule 2.06 of the ISP98

Subrule 2.06 (a) provides for situations under which the applicant wishes to include an automatic amendment to the standby. In commercial LCs automatic amendments are typically used in revolving LCs where the LC shipments are reinstated automatically depending on either time or value.

Since the standby is an irrevocable instrument, it can not be amended or cancelled by the issuer without the agreement of the concerned party, that is, the beneficiary. In automatic amendment(s) which a standby is made

subject to, however, the situation is different in that no consent is required for such amendment(s) to become effective, unless of course the text of the standby stipulates otherwise. This is because an automatic amendment incorporated in a standby text is considered a condition of the undertaking itself. A standby can automatically amend the amount, the validity date or the like.

Subrule 2.06 (b), if the standby does not contain any provisions for automatic amendment(s), the issuer is irrevocably bound by the amendment once the amendment leaves the issuer's control. The confirmer also becomes bound by the amendment once it leaves its control unless the confirmer elects not to add its confirmation to the amendment.

Two additional points regarding issuance of amendments must be understood:

i. The issuer of a standby is not obliged to issue an amendment thereto.

ii. The confirmer of a standby may or may not elect to add its confirmation to an amendment. The confirmer can also qualify its confirmation of an amendment (e.g., for two years of a four years standby).

Subrule 2.06 (c), if the standby does not contain any provisions for automatic amendment, the beneficiary must consent to the amendment for it to become binding; Once again, since the standby is an irrevocable undertaking of the issuer, it can only be amended with the consent of the person affected. Hence, for an amendment to become effective, the beneficiary must approve it in either one of the following methods:

i. To send its consent in writing to the advisor, nominated person, confirmer, or issuer as appropriate.

ii. To present documents which comply with the amended standby. In such case, the beneficiary implicitly conveys its consent to the amendment since the beneficiary complied with the terms of such amendment in presenting documents.

Subrule 2.06 (c) (iii) although the issuer only issues amendment upon receipt of the applicant's instruction to do so, the applicant's consent is not required to make the amendment binding on the issuer, confirmer or beneficiary.

Where an amendment contains several terms, and the beneficiary presented documents that comply with part of these terms, the documents would be discrepant because consent to only part of the amendment is a rejection of the entire amendment.

3.7 ROUTING OF AMENDMENTS

Read now Rule 2.07 of the ISP98

Rule 2.07 (a) states that whenever an issuer advises a standby through a specific person, it must also advise all amendments through the same person. This is essential in cases where the nominated bank agrees to act on the nomination of the issuing bank, that is, it will check the documents presented under the standby and pay the value of complying presentation.

Rule 2.07 (b): Now imagine if the issuing bank issues an amendment to the standby and advises such an amendment through a third different bank without notifying the nominated bank who originally advised the credit. In such a situation, the beneficiary may present compliant documents in accordance with the amended standby to the nominated bank who will eventually check the documents against the original standby and will reject them since they do not comply with the original terms not amended in its records. Here the issuing bank will be responsible for the damages incurred by the beneficiary as a result of the misrouting of the amendment.

The issuer will also be liable to the nominated person who because of the misrouting, relied on the unamended standby without notice of the amendment. Suppose the standby was amended and the amendment was advised through a third bank who in turn forwarded it to the beneficiary and the beneficiary accepted it, hence the standby became amended. Nevertheless, the beneficiary presented documents that comply with the unamended standby terms to the bank that advised the original standby. Upon checking the documents against the original unamended standby terms, the advising bank found that such documents were compliant and therefore honoured the presentation but was first unable to recover reimbursement. The issuing bank here again bears the full responsibility and is bound to reimburse the nominated bank who acted in the scope of its nomination in honouring the conforming documents in its records because it did not receive the amendment which the issuer routed to the beneficiary through a third different bank.

Hence, the amendment once accepted by the beneficiary becomes effective as to beneficiary, transferee or nominated person to whom it was advised even if it was misrouted by the issuer; this is because the amendment once issued is an irrevocable undertaking (Rule 2.06 (b) – ISP98).

According to Rule 2.07 (b) the above also applies to a notice of cancellation.

Subrule 2.07 (c), in evergreen standbys, the undertaking is automatically extended to a new period unless the issuer issues a notice of suspension (instruction to cease the validity of the LC). This subrule states that a nominated person acting within the scope of its nomination prior to the receipt of the notice of non renewal (suspension) from the issuer will remain eligible for reimbursement by the issuer.

CHAPTER 4

Presentation

4.1 INTRODUCTION

In order to receive payment upon drawing under a documentary credit, the beneficiary must present the documents stipulated by the LC in full compliance with the credit terms and conditions.

Under the doctrine of strict compliance, the issuer is obligated to pay the beneficiary only if the documents presented under the letter of credit appear on their face to comply strictly with the terms and conditions of the credit. If the documents do not appear to comply strictly with the credit, the issuer is not obligated to honour the beneficiary's presentation. The American UCC, Article 5 emphasizes that strict compliance standard does not require that the documents presented by the beneficiary are an exact mirror image of the letter of credit. 'Strict compliance does not mean slavish conformity to the terms of the letter of credit.' In support of this doctrine, said UCC Article cites approval cases in which minor discrepancies have been disregarded by the courts. Trivial or immaterial mistakes or misspellings should not prevent honour. 'The strict compliance standard is not a mirror image standard,' nor does it demand 'oppressive perfectionism.'

The point to remember here is that strict compliance doesn't necessarily have to mean exact repetition of the wordings in the LC although it may do so as in the circumstances depicted by Rule 4.09 of the ISP98 interpreted beneath. Furthermore, it is necessary to understand that the UCP600 addresses the issue of checking documents in somehow a different way than the ISP98, hence, it is necessary to draw a clear distinction between the different practical principles applied to checking documents under both sets of rules; the ISP98 and the UCP600.

4.1.1 Complying presentation under standby letters of credit

Rule 3.01 of the ISP98

This rule indicates how a standby should be structured with respect to presentation, that is, it should specify the time, place, location within that place and the medium of presentation. It also recognizes that a standby may indicate the person or position to whom presentation should be made. To the extent that a standby does not so indicate, the presentation must be made in accordance with the ISP98 rules in order to comply.

The rationale behind this is that many standbys' issuers are major institutions with many branches and departments. Thus delivery of the documents to any of these branches or departments does not necessarily mean that such documents will directly reach the standby department. Furthermore, even if the documents reached the standby department directly where the issuer handles thousands of LC transactions, it does not mean that the documents will be processed directly as such issuers frequently distribute work between numerous staff. The medium of presentation is also important because documents presented by mail (paper based documents) for example, are processed differently than processing electronic documents or faxed documents. The standby should provide specific instructions for the particular medium used (e.g., the receiving fax number).

4.2 WHAT CONSTITUTES A PRESENTATION

Rule 3.02 of the ISP98

According to this rule, submitting any document under the standby is a presentation requiring examination for compliance with the standby terms and conditions. Hence, the beneficiary may either present the full set of documents required under the standby to the concerned person or may present any part thereof and the submission in both cases is considered a presentation. Upon examining such documents, the concerned person, that is, the issuer, nominated person or confirmer will then determine whether the presentation is in conformity with the terms and conditions of the standby or not. This necessarily means that the presentation of documents need not be complete or conforming; however, the issuer must always check the documents, within a specific period of time after receiving it (Rule 5.03), to

determine whether or not it complies with the stipulations of the standby, otherwise it will be precluded from claiming that the documents are not compliant and becomes obliged to honour its value.

If the beneficiary only presented part of the documents and requested the person concerned (issuer, confirmer or nominated person) to hold it until other remaining document(s) are delivered, the issuer or the person concerned can and normally does refuse such request because it subjects that person to the risk that the standby may expire whilst the documents are held at its counters. Where the issuer or other concerned person agrees to hold the documents until the remaining documents are presented, the presentation is deemed to have been made upon the submission of the last document under the standby, so if the last document is submitted after the expiry date whilst the other documents were submitted during the validity of the standby, the presentation is discrepant and the presenter bears the consequences.

4.3 IDENTIFICATION OF THE STANDBY

Rule 3.03 of the ISP98

Once the concerned bank undertakes a presentation, it becomes necessary to access the standby and amendment. Hence, the bank must be able to immediately identify the standby under which the presentation is made. Delays may occur in checking documents if the beneficiary fails to correlate the presentation with its standby LC.

The beneficiary or presenter of documents must ensure that the standby reference number is stated on the documents in order to ascertain the issuer is capable of determining that the documents pertain to the relative standby immediately upon receipt so it may proceed with the documents checking process.

Stating the standby reference number on the documents is not the only means by which identification of the standby can be made; attaching a copy of the standby with the documents presented under the same standby is another method by which the standby may be identified.

Now it is obvious that the examination of documents can not begin before associating such documents with the relative standby. Delivery of documents without any clear indication as to the standby they are presented under may result in delay in processing until the connection is established. For example, if the documents are presented to the mail department without any proper identification, they may be sent to the commercial credits department and will remain there until such time as the presentation is identified;

a matter that causes delay, and the consequences are to be borne by the beneficiary who failed to abide with the provisions of this rule. Here it is important to note that the issuer is obliged to check the documents only once these documents are properly identified.

Even if the documents declared they are presented under a standby without specifying the standby's reference number, a delay may occur if the department is processing a large number of standbys for the same applicant and beneficiary. Here again the consequences of the delay are the responsibility of the presenter and the issuer is only obligated to check the documents once they are properly identified.

It is interesting to note here that the beneficiary's failure to abide with this rule does not allow the issuer to dishonour the presentation even though the rule acknowledges the beneficiary's need to have the standby reference number declared on or with the presentation. The rule merely allows the issuer to delay checking the presentation until the documents are identified.

Suppose that the standby stipulates that the presentation must contain the LCs reference number. In such case, failure of the beneficiary to include the reference number of the standby will not justify dishonour by the issuer (ISP98 Rule 4.09 – Identical Wording and Quotation Marks) unless the standby stipulated that the wording be exact and identical. It is worthwhile mentioning here that such a requirement in a standby can be waived by the issuer in its sole discretion (Rule 3.11 (a) (i) Issuer Waiver and Applicant Consent to Waiver of Presentation Rules).

According to this rule, the issuer is neither obliged to check the presentation before it is identified, nor is it obliged to expedite the search to identify the presentation. If, however, the standby expired before the presentation is identified, the issuer will treat the presentation as discrepant (late presentation of documents) and the beneficiary will bear the responsibility; the essence of Subrule 3.03 (c).

4.4 WHERE AND TO WHOM COMPLYING PRESENTATION IS MADE

Rule 3.04 of the ISP98

This rule states that the presentation must be made in the place and location stipulated by the standby. If not so the presentation must be made in accordance with the ISP98 provisions, otherwise it will be considered discrepant.

The rule encourages the practice of including the place, location and the person to whom the presentation must be made in a complete and precise

manner. This is because the issuer may have several locations in the same city and if the presentation was made to the wrong location a delay in processing the documents may occur and the consequences may be an expiry date discrepancy.

Subrule (b) states that if the place of presentation was not indicated in the standby, the presentation must be made to the place from which the issuer issued the standby.

Subrule (c) states a very important provision that allows the presenter to submit documents to the issuer in case of a confirmed standby when confirmation does not contain any stipulation on the place of presentation of documents. A presentation made to the issuer in such a circumstances binds the confirmer.

The subrule also allows the presenter to submit documents to the confirmer at the place from which the confirmation was issued in case there is no place of presentation indicated in the confirmation.

Subrule (d) clarifies that if the standby did not include a location within the place stipulated for presentation of documents, the documents may be delivered to

1. The general postal address indicated in the standby;
2. any location at the place designated to receive deliveries of mail or documents including any address shown in the nomination or cover letter in case the standby was advised by the nominated bank; or
3. any person at the place of presentation actually or apparently authorized to receive it.

The rule uses the word location to stress that delivery to the street address of a standby does not necessarily mean that the documents will reach the standby department. Hence, the rule suggests specifying the address in the standby for delivery of documents with precision. The documents may also be submitted to any person at the place of presentation who is actually or apparently authorized to receive them. This means that delivering the documents to a teller in a branch, for example, does not mean that a presentation is made. The presentation will be made once the documents are received by the central mail point responsible for forwarding the documents to the standby department or if the documents forwarded directly to the standby department, delivery will be made once they receive it.

If the standby specifies the name or title (e.g., Manager Standby Department) of a person to receive the documents then the documents must be delivered to that person. However, it is preferable not to use designations as this may cause difficulties due to the staff turnover or absences and change of designations or responsibilities. Hence, the rule provides that

presentation may be made to any person actually or apparently authorized to receive them. The person actually authorized to take delivery is the mail clerk who signs for deliveries and the person apparently authorized to take delivery is the receptionist who normally takes delivery of documents and signs for them.

4.5 WHEN TIMELY PRESENTATION IS MADE

Rule 3.05 of the ISP98

The presentation must be made within the standby validity period for it to be compliant; the validity period starts at the moment the standby is issued and ends on the day following the expiry date. This means that presenting documents on the expiry date is allowed, however, presenting documents after the expiry date constitutes a late presentation discrepancy. Rule 1.09 of the ISP98 defines the term 'Expiration Date' as the latest day for a complying presentation provided in a standby. Further, Rule 9.01 dictates that the standby must contain an expiry date or it must permit the issuer to terminate the standby upon reasonable prior notice of payment. It is also useful here to note the provision of Rule 9.04 which states that if no time of day is indicated for expiration, it occurs at the close of business at the place of presentation.

Even though this rule provides that presentation may be made at any time after issuance, the standby may restrict presentation(s) at specific future dates by incorporating terms such as 'presentation may not be made until April 2007'.

Notice that some standbys restrict their availability by requiring performance of an act which may be ascertained by the issuer from the issuer's own records or within the issuer's normal operations, for example, if the standby contains the term 'available when the beneficiary makes payment of USD25,000,000 in the account of Mr. Raymond' or presentation of documents. Here if the condition is documentary, it becomes necessary to search within the terms of the standby to determine when exactly the time for presentation begins. However, if the condition is a non-documentary one, it must be disregarded.

Rule 3.01 (a) also states that presentation is timely if made 'before expiry on the expiration date'. Of course the expiration date must be determined from the standby, or if this is not possible, it must be determined from applicable law (e.g., UN Convention Article 12).

Subrule 3.05 (b) states that presentation made after the close of business at the place of presentation is deemed to have been made on the next business day. This subrule uses the word 'day' to indicate a business day at the place of presentation and not the 24 hour cycle of the clock. This is to dictate that a presentation made after the close of business at the place of presentation means that presentation is made on the next business day, unless of course the standby stipulates otherwise. Rule 3.11 (a) (iv), however, provides that the issuer can allow the presentation to be made after the close of business without affecting its right to reimbursement.

If documents are presented on the expiry day and that date was closed for business Rule 3.13 (Expiration Date on a Non-Business Date) and 3.14 (Closure on a Business Day) both provide for circumstances when the last day for presentation falls on a non-business day at which the issuer is closed for ordinary reasons or when the issuer is closed for any other reason like in the cases of force majeure.

The standby may provide for other time limits besides the expiration and, if it does so, presentation must abide with this date in order to be compliant, that is, it must not be made after this date.

4.6 COMPLYING MEDIUM OF PRESENTATION

Rule 3.06 of the ISP98

According to Subrule 3.06 (a), whenever a standby stipulates that documents must be presented in a specific medium, then documents must be made in that stipulated medium otherwise it will be discrepant.

Subrule 3.06 (b) affirms the general practice amongst banks and applicants that documents will normally be presented in paper form. Although electronic documents are sometimes accepted as a valid presentation under a standby, the paper documents are still the predominant form of presentations under all types of documentary credits. This is mainly due to the legal character of some transport and commercial documents such as the marine bill of lading which represents a document of title and can be endorsed by signature and delivery whilst the case is not so if the bill of lading is presented electronically. This is because it is only possible to authenticate electronic presentations by acceptable methods if all participants in the LCs' transactions are members of one unified system of communication such as the Bolero system. A membership in a globally accepted system of this sort would allow authentication of electronic presentations same as the

case in SWIFT where messages received from members get authenticated automatically.

Subrule (b) also states that if the standby merely requires the presentation of a demand without any other documents, then the demand need not only be presented in document form, it can also be presented via (a) tested telex if the beneficiary is a bank, (b) SWIFT. if the beneficiary is a SWIFT. member or any other means that can be authenticated by the issuer. Other than that, a demand that is not presented as a paper document does not comply unless the issuer permits in its sole judgment the use of that media.

Subrule (c) clarifies that any document sent by electronic means to the issuer or any other concerned person will not be treated as a paper presentation even if the receiver generates from it a paper document like making a print out of the document, for example.

Subrule (d) provides that the issuer, the nominated person or the confirmer must always be able to authenticate documents presented electronically in cases where the standby allows the presentation of documents electronically. Otherwise, the presentation will be considered discrepant. Same as in Rule 1.09 that defines the electronic terms, this provision reflects that the ISP98 encourages the practice of presenting electronic documents.

It is important to note here that Subrule (b) (ii) permits the issuer to accept a presentation of a demand from the beneficiary electronically. So the issuer could exercise its discretion to accept a demand by fax.

4.7 SEPARATENESS OF EACH PRESENTATION

Rule 3.07 of the ISP98

Regardless of whether or not the standby prohibits partial or multiple drawings, this rule allows the beneficiary of a standby to resubmit a presentation in the following events:

a. If the beneficiary presented discrepant documents, then the beneficiary can amend the documents and represent it again provided that this is done before the expiry of the standby. As such, this rule expressly allows the beneficiary to cure discrepant documents if this is done in good time.

b. If the beneficiary withdrew a presentation, then the beneficiary can resubmit it provided this is done within the standby validity period.

c. If a beneficiary fails to make one presentation on a prescheduled date or period, the beneficiary can still make other presentations at their respective dates. This is irrespective of whether or not the standby prohibits partial or multiple drawings.

Contrary to the above is Article 32 of the UCP600 that prohibits drawings/instalments subsequent to a presentation that was not made on time in a commercial LC which allows instalment shipments or drawings. The reason for this contradiction stems from the different nature of both commercial documentary credits and standby documentary credits; the latter is often issued as means of security (back up) for transactions involving a series of performances. In such circumstances, it is expected that drawings will only be made at such times when the applicant fails to perform as agreed.

Subrule (b) substantiates the general LC practice that each presentation is a separate one and therefore a wrongful dishonour of one presentation does not reflect in any way on future presentations and the issuer or any other concerned person is bound to check each future presentation on its own.

Subrule (c) states that a bank which wrongfully honours a presentation that contains discrepancies is under no obligation to give notice of these discrepancies. Such a bank will not be obliged to honour future presentations containing similar discrepancies under same standby on the grounds that such discrepancies were previously accepted.

4.8 PARTIAL DRAWINGS AND MULTIPLE PRESENTATIONS; AMOUNT OF DRAWINGS

Rule 3.08 of the ISP98

Subrule 3.08 (a) allows the beneficiary to make a short drawing on the standby that is to draw for less than the value of the standby. So if the standby is for USD70,000 the beneficiary can demand payment of USD60,000 by presenting compliant documents. Such a drawing is called Partial Drawing.

Subrule (b), allows the beneficiary to submit several sets of documents (Multiple Presentations) and thus drawing several times provided that the sum of the amounts of the separate partial drawings does not exceed the value available under the standby. Let's take an example, in a standby letter of credit that has a value of USD25,000, the beneficiary can draw five separate drawings on the Letter of Credit by presenting, during the validity of

the standby letter of credit, five compliant sets of documents each for USD5000. The partial drawings of course need not be equal but must not exceed the value available under the standby.

The exception to the above Subrules (a) and (b) is the case where the standby expressly prohibits partial drawings and partial presentations respectively.

Here the ISP98 is similar to the UCP that embodies commercial LC practice under which the entire LC merchandise need not be shipped at once and, consequently, the commercial documentary credits need not be drawn on in one drawing unless expressly so provided in the credit text.

Going back to Rule 1.09 (Defined Rules), the ISP98 clarifies that the term Draw/Drawing is used in two different ways, depending on the context; (1) 'to demand payment' (as a verb) or (2) 'a demand for payment' (as a noun).

The ISP98 here introduces a very important distinction between partial and multiple drawings. In a standby that prohibits partial drawing, it is most likely that the intentions of the parties are to allow one drawing. Furthermore, it is unlikely that the parties would prohibit a drawing for less than the full amount. In commercial documentary credits that prohibit partial shipments the case is different because drawing a lesser amount means that the goods shipped are less than what was agreed upon in the underlying transaction which would normally be undesirable for the applicant. By introducing the notion 'multiple drawing', ISP98 extinguishes doubt and directs the parties to clearly state their intentions.

Always remember the following rule of thumb:

'A standby that prohibits Partial Drawing: allows only one drawing (presentation) that must be made for the full amount of the standby.

However, a standby that prohibits Multiple Drawings: allows only one drawing but permits it to be short, that is, for less than the full amount.'

This rule of thumb represents the content of Subrules (c) and (d) of the ISP98.

Occasionally trade finance practitioners would come through the wordings 'multiple drawing'. Multiple drawings is identical to multiple presentations, nevertheless, the term multiple presentation is used to substantiate the technical distinction between partial drawing and multiple presentations.

Subrule (e) provides that the claim under a standby must not exceed the value available under such standby and in all circumstances. A presentation that includes a demand for an amount in excess of the standby permitted value is a discrepant presentation. However, a complying presentation may contain documents other than the demand and such documents may hold a value that exceeds the amount available under the standby; in such cases the presentation would not be discrepant and the bank concerned is bound to honour it. This is because standby LC often cover only a part of an amount

due to the underlying transaction. Beneficiaries frequently present documents bearing amounts larger than the amount claimed or available under the standby. Again, such documents if presented together with a complying claim, the presentation in its totality conforms to the standby terms and conditions and thus must be honoured if the other terms and conditions of the standby are also adhered to.

Subrule 3.08 (f), provides for the situations where the amount to be drawn under the standby will be uncertain at the time of issuance as in the case where it is required to pay a varying interest rate, for example. In similar situations, applicants frequently require that a drawing be in the range of 10 per cent (plus or minus) of the amount indicated or the quantity in question. Such requirement is indicated in the text of the standby by using the word 'approximately', 'about', 'circa' or similar words.

4.9 EXTEND OR PAY

Rule 3.09 of the ISP98

A beneficiary of a standby may present a demand for the issuer, nominated person or confirmer if any, prior to the expiry of the standby requesting to extend its validity period or else pay the value available under it. Since the standby is mostly available by presenting a simple demand that conforms to the standby requirements, and since the concerned banks are obliged to honour such demand by merely presenting it, the beneficiaries prefer to do so to protect their interest in circumstances where the underlying transaction is not completed within the original time agreed upon between the contracted parties (the beneficiary and applicant).

In standby LC operations, such circumstances may result in serious problems for the banks. This is how it happens. Upon presenting the demand to extend or pay for the bank, the bank contacts the applicant who in turn tries to leave the bank with the impression that such demand in not urgent and it will be withdrawn in a short time as the beneficiary and the applicant are in current negotiation of the new terms of the underlying transaction and about to agree on them. Of course the bank here must ignore the applicant's assuring remarks and must check the demand to prepare it for payment regardless of the applicant's position. Such payment against a compliant claim may be halted only if the applicant agreed on the beneficiary's request for the extension of the standby and so instructed the bank. The bank's anxiety will be heightened if the expiry date of the standby is very close.

Make sure that you understood the previous paragraph before preceding to the following part of this article. Further, try to apply Rule 5.01 of the

ISP98 (Timely Notice of Dishonour) and Rule 5.03 of the ISP98 (Failure to Give Timely Notice of Dishonour) to the operational problem depicted in the same paragraph in order to clearly understand the consequences on the bank/the issuer when it fails to act in an a sound manner upon receiving a beneficiary's request to extend or alternatively pay.

Hence, the request to extend the expiry date or pay the amount available under the standby is a presentation that must be checked in accordance with the ISP98 provisions and against the stipulations of the standby. This is what Subrule 3.09 (a) of the ISP dictates.

Two points remain to be mentioned here:

1. Since the *demand* is in essence a presentation that falls within the definition of presentations in Rule 3.02 of the ISP, then calculation of the time for examination begins upon receipt of the demand.
2. The issuer is in no way obliged to refer to the applicant upon receiving the beneficiary's request to pay or extend. The issuer can directly treat the request (demand) as a presentation and examine it for compliance without referring to the applicant.

Subrule 3.09 (b) of the ISP provides for the situation where the issuer elects to treat the *demand* as a request for an amendment to extend the expiration time rather than a *demand* for payment under the standby. In such a situation, the issuer has the right to request the applicant's consent, and, if the latter consented the issuer may then automatically amend the standby without referring to the beneficiary any more as the issuer assumes that the beneficiary's presentation of the demand for extension is an implied consent to the amendment. Furthermore, the rule states that once the amendment is issued, the demand for payment is automatically withdrawn.

Subrule (b) (iv) of the ISP affirms that the issuer has the full seven banking days (Rule 5.01 ISP) to examine the documents and determine whether or not they are presented in conformity with the standby stipulations and ISP98 provisions. The beneficiary consents to the time limits set in this subrule.

Note here that the issuer is not obliged to accept a request for extending the standby even though the applicant consents to the extension.

It remains to say here that even if the standby expires during the seven business day period following the date of receipt of the 'extend or pay' request, and the extension was not consented to by the applicant or the issuer or both, the issuer here is obliged to honour the value of the demand only if the presentation is compliant. If the presentation contains discrepancies, then the issuer can decline payment in accordance with the ISP98 provisions. So, for example, in a standby that expires on 25 November 2009, a demand is presented on 23 November 2009, the issuer checks the

documents on 27 November 2009 and finds it to be compliant, then the issuer is bound to pay its value even though payment is to be made after the validity of the standby.

4.10 NO NOTICE OF RECEIPT OF PRESENTATION

Rule 3.10 of the ISP98

Contrary to Article 17 of the URDG, the issuer does not have any duty to notify the applicant when the beneficiary draws on a standby.

Standbys are often drawn upon when there is a dispute between the applicant and beneficiary in a default situation. In such circumstances the issuer is obliged to honour the drawing by mere presentation of stipulated documents since the issuer is a neutral party to the standby. If the issuer gives a notice to the applicant upon receipt of the presentation, the applicant may attempt to prevent payment by seeking a court order. Not only such notice would question the integrity of the issuer, but would also subject it to legal liability. The notice of payment will naturally have to be given to the applicant at or after honouring the presentation.

4.11 ISSUER WAIVER AND APPLICANT CONSENT TO WAIVER OF PRESENTATION RULES

Rule 3.11 of the ISP98

This rule allows the issuer to exclude (waive) the application of the following rules without obtaining the applicant's consent or even referring to the applicant:

1. Rule 3.02 (What Constitutes a Presentation) addresses the method by which documents presented must be treated; including documents presented in parts at different dates.
2. Rule 3.03 (a) provides that every presentation must indicate the standby reference number it relates to.

3. Rule 3.04 ((b), (c) and (d)) address operational issues related to the place presentations should be made at and the person to whom the presentation should be made.
4. Rule 3.05 (b) treats a presentation made after the close of business as if it was made on the next business day.

This rule governs the standby's terms which were placed by the issuer for its own administrative convenience, that is, to ensure orderly processing and payment. Although they too must be adhered to by the beneficiary, these terms are in essence different from the standby's other documentary conditions originally placed by the applicant. Hence, this rule gives the issuer the right to waive said administrative rules without referring to the applicant or acquiring the applicant's consent.

Read the interpretations of the above rules again and make sure that you clearly understand how they differently apply to terms other than the documentary conditions originally stipulated in the standby by the applicant itself.

The ISP98 here, and in other similar rules such as Rule 3.12 of the ISP98 (Original Standby Lost, Stolen, Mutilated or Destroyed), notifies the applicant in advance of the issuer's right to exercise its discretion within these areas. The rational behind this early notification is to preclude the applicant from taking advantage of a fortuitous discrepancy that is unrelated to the documentary conditions originally set by the applicant himself. It is an attempt to protect the beneficiary by discouraging the applicant from insisting on a discrepancy which from its perspective is a minor one. A similar situation arises in commercial LC where applicants are discouraged from using trivial discrepancies that do not cause ostensible damage to the applicant as an excuse to halt payment.

Once again, the applicant may modify or exclude these rules prior to the issuance of the standby by expressly including terms in the standby text to that effect.

Subrule (a) in addition to the four subrules mentioned above, also allows the issuer to waive '… any similar terms stated in the standby which are primarily for the issuer's benefit or operational convenient'. Let's take an example, in a standby which stipulates that documents must be dispatched by Courier, but the beneficiary sent the documents by airmail, the issuer may disregard this trivial discrepancy and may waive this requirement without having to obtain the applicant's consent; it is a requirement that was made for operational convenience.

Determining whether a particular term was incorporated into a standby primarily for the operational convenience of the issuer is based on the standard standby practices rather than depending on the level of involvement (persistence) of the applicant in incorporating the term in the text of the

standby. Even if the condition is one that has some benefits for the applicant, it still can be waived by the issuer if it is a term that banks regularly insert for operational convenience.

Reimbursement instructions in a standby, or other correspondent banking provisions which normally are unrelated to the applicant, would also be encompassed by this rule, that is, the issuer may waive any requirements related thereto without needing to consult the applicant. According to Rule 2.06 of the ISP98, amendments to reimbursement instructions or any other terms concerning a correspondent, agent or a branch of the issuer (inter-bank terms), do not require the beneficiary's consent as long as such terms do not affect its rights under the standby. Here again the issuer may waive such requirements.

In Subrule 3.11 (b) of the ISP98, the Issuer is permitted to waive the provisions of Rule 4.06 and Rule 4.04 of the ISP98 only if the text of the standby does not require compliance with such provisions. Hence there is a structural difference between Subrule (a) and Subrule (b), in that Subrule (b) allows the issuer to only waive the rules of the ISP98; however, this subrule precludes the issuer from waiving such requirements if they are also stipulated in the text of the standby either by using same terms or using similar terms.

To re-emphasize, Subrule (b) only applies if the standby does not contain any stipulations leading to the same effects as Rules 4.04 and 4.06 of the ISP98; any such express terms in the standby would render the rule inapplicable. To the contrary, modifying or excluding the parts treated in Subrule (a), it is necessary to include an express term in the text of the standby to that effect as the subrule applies to both the text of the standby and the ISP98.

Subrule (c) allows the issuer to waive the requirements of the Rule 3.06 (b) of the ISP98 without referring to the applicant only when the issuer has received the demand in an electronic medium from the true beneficiary.

The Confirmer needs the consent of the issuer to be able to waive the requirements under paragraphs b and c of this rule.

4.12 ORIGINAL STANDBY IS LOST, STOLEN, MUTILATED OR DESTROYED

Rule 3.12 of the ISP98

This rule addresses the situation where the original standby (the instrument that was first transmitted via the issuer's electronic system or mailed by the issuer upon issuance) has been lost, stolen, mutilated, or destroyed. In such

a situation, the issuer is not under any obligation to issue a replacement; it may exercise its own discretion and issue the needed replacement but it (the issuer) is not obliged to do so. The same applies whenever the standby text stipulates that the beneficiary must present the original standby upon drawing, the issuer is free to either waive or keep the term in the standby that requires the presentation of the original operative instrument.

Subrule (b) of the ISP98 provides that in cases where the issuer agrees to replace a lost original standby or waive a requirement for its presentation, it must mark the replacement or copy as a cautionary note to warn that person who may rely on it for any reason (warn from fraudulent attempts that might take place by those who have possession of the original standby). By marking the replacement as such, the issuer fully protects its rights to reimbursement from the applicant says Subrule 3.12 (a) of the ISP98. It is useful here to recall the provisions of ISP98 – Rule 3.11 that allowed the issuer, in certain cases, to waive those terms that were merely drafted for operational convenience.

Subrule (b) also allows the issuer to demand the applicant to provide adequate indemnities and assurances from any nominated person that no payment has been made against the original standby.

The original operative standby instrument in itself has no significant value as the standby is not a negotiable instrument, although it may give rise to the creation of negotiable instruments such as drafts or promissory notes. The standby value is in the issuer's undertaking it embodies (and that of the confirmer if any). The original standby, however, does have practical and administrative uses for the parties to the standby transaction with respect to negotiation, payment by a nominated bank, assignment of proceeds, partial payments or similar matters.

4.13 EXPIRATION DATE ON A NON-BUSINESS DAY

Rule 3.13 of the ISP98

Subrule 3.13 (a) states that a standby LC must contain an expiry date or permit the issuer to terminate the standby upon reasonable prior notice or payment. In addition to the expiry date, standbys frequently contain terms that fix the latest date by which documents can be presented. If the documents were presented to the issuer or nominated person on the expiry date or the latest date allowed for presentation and such date was a non-business day, then documents presented on the first following

business date are considered timely and will be accepted. The same applies to any deadline for presentation of documents, that is, if this date was on a non-business day, then documents may be presented on the following business day.

Before moving on to Subrule (b) of the ISP98, it is useful here to revise the distinction between the terms 'Business Day' and 'Banking Day' as defined in Rule 1.09. Further, it is important to be able to correlate the provisions of Rule 2 (b), (c) and (d) with regards to the term '*TIMELY*' with those of Rule 3.13 of the ISP98.

Where the presentation is made to the nominated person/bank on the last date allowed for presenting documents and this date was a non-business day, then the nominated bank will receive it in a timely manner on the first following date. In addition, this rule obliges the nominated bank here to represent (certify) to the issuer that the presentation was timely received. Normally banks do so by using the phrase 'we hereby certify that documents were presented within the validity of the credit', or similar wording. Note here that although the rule forces the nominated person to advise the issuer, it neither addresses the position of the confirming person/bank, nor does it specify the capacity the nominated person is acting under, that is, is it a nominated person that has accepted its nomination and is acting accordingly or is it a nominated person who has not accepted its nomination and is acting merely as an advising person? This is important as an advising person normally acts without any responsibility on its part and merely performs the functions of a post office. If such a person is required to represent that documents were presented in a timely manner, this could lead to hold it liable for the whole value of the documents if it fails to so certify.

4.14 CLOSURE ON A BUSINESS DAY

Rule 3.14 of the ISP98

Subrule (a) provides for the situation where documents are presented in the following circumstances:

1. The presentation is made on the last date allowed for presenting documents, and
2. it coincided that at this specific date the place for presentation was closed, where

3. the closure could be for any reason – including a force majeure situation – other than the reason specified in the previous rule (Rule 3.13 of the ISP98; Closure on a Non-Business Day), and
4. as a result of the closure, the presentation is not timely made.

The last day for presentation will automatically be extended to the day occurring 30 calendar days after the place for presentation reopens for business, unless the standby provides otherwise.

By specifying the closure may be 'for any reason', the rule eliminates the need to investigate whether there has actually been a force majeure and if so where, when, and for how long such a force majeure has taken place. What matters is the closure of the issuer (or other nominated person or confirmer) on a day that it is normally scheduled to be open for business. As such, closure of an issuer for being insolvent, would not subject the beneficiary to the risks of forfeiture of its rights.

You may have noted that there is a substantial difference between the way the ISP98 addresses force majeure and that of the UCP. Under the UCP, the bank concerned is not obliged to honour a compliant presentation made late because of a force majeure after such bank reopens for business. Conversely, the ISP98 obliges the concerned person (issuer, confirmer or nominated person) to accept a complying presentation made after a force majeure up to 30 calendar days after said concerned person reopens for business.

This rule applies to all standbys under which presentations must be made to the issuer, to the confirmer, or to a nominated person authorized to act under the standby. However, the rule does not apply to freely negotiable standbys as these can be presented in multiple places.

One thing remains to say here; the beneficiary would be able to benefit from the 30 days extension under this rule only in case it (the beneficiary) was able to submit a complying presentation at the specified office/place had this office been open on the last business day for presentation. How these facts are to be established is not addressed in this rule. It is implicitly understood that once the issuer honours a complying presentation after the closure on the last day for presentation, it becomes entitled to reimbursement from the applicant.

Subrule 3.14 (b) of the ISP98 allows the issuer to designate a different *reasonable* place for presentation in addition to the original place upon or in anticipation of closure of the place of presentation. This precautionary measure permits the beneficiary to present the documents at the alternative designated place instead of waiting for the reopening of the original place for presentation. The designation of the alternative place for presentation of documents can either be incorporated by a term to that effect in the text of

the standby or by a separate communication (letter, email, telex … etc.) that must have been received by the beneficiary. So the issuer is obliged to prove that the beneficiary has received the communication.

The rule uses the words 'reasonable place' which means that such a place is not located at a materially far distance from the location of the beneficiary or for some reason, political for example, can not be reached.

Subrule 3.14 (b) ISP98 addresses the situation where the closure of the place of presentation is planned in advance such as in the case of closing down an unfeasible branch. The subrule allows the issuer to give a notice of the closure to the beneficiary within an adequate time frame to enable the beneficiary to adjust its plans accordingly. The important point to note is that there will be no extension of time under Subrules (a) or (b) if the communication containing the notice of closure was received more than 30 calendar days before the date of the last presentation, therefore, the beneficiary will have to submit its presentation in the new designated place since it will have sufficient time to do so. To the contrary, if the communication is received less than 30 calendar days from the last date of the presentation and because of that the presentation was not timely made, the extension becomes due and the beneficiary will be allowed to present the **documents** at any time within the 30 calendar days following the last date for presentation stipulated in the standby. Naturally, if the text of the standby contains a term that stipulates a different time period for the presentation following the closure date (say 15 calendar days I/O 30) then the beneficiary will have to present its documents within the new time frame, that is, 15 calendar days, and since the ISP98 rules supplement the standby terms and conditions, the other provisions of the rule remain unaltered unless expressly modified or excluded by the standby.

4.14.1 Force Majeure in construction contracts

Any discussion of LC or bank guarantees used on international construction projects is incomplete without mention of force majeure and some of the other more exotic defences that may prevent honour.

Force Majeure events are those unfortunate incidents that can not be prevented even by exercising the strictest operational controls and due care of the party claiming damages as a result of their occurrence. An example would be natural disasters like hurricanes or earthquakes.

Due to the relatively large values of construction contracts, owners are particularly cautious about force majeure events and for that reason they include comprehensive protective clauses in the construction contracts with the contractor. As we saw earlier, in cases of contracts secured by standby LCs, Rule 3.14 (a) of the ISP98 allows a period of 30 calendar days – after the place stipulated for presentation of documents reopens for business – to

present the documents in the aftermath of a force majeure. Generally speaking, so is the case in projects secured by performance guarantees where the performance obligation of the contractor is halted until the time at which the effects of the force majeure events are ended and business is resumed at the place of the project.

In some construction contracts, the contractor not only becomes entitled to extra time for the consummating of the project, but also receives impact costs which are financial aid and compensation to cover the monetary damages suffered as a result of an event of force majeure.

A force majeure event does not render void the bank's undertaking issued to secure the performance of a construction project in favour of the owner as long as the text of the undertaking allows the resumption of work in the aftermath of the force majeure. Conversely, if the text of the undertaking prevents the owner from drawing on the instrument in question in cases of force majeure, the owner can not claim under the instrument. In all cases, if the instrument in question was subjected to a set of rules which allows extension of the validity of the instrument and as such allows the beneficiary to draw on it, then the provisions of the governing rules prevail.

It is useful to recall that under the independence principle (see Chapter 15, Section 15.1.2), the underlying transaction is totally independent of the bank's undertaking under a standby letter of credit and as such the force majeure event does not effect the validity of such an undertaking.

Should the terms of the standby LC or altered governing rules state that the bank's undertaking will be automatically extinguished in the aftermath of a force majeure and, without the knowledge of the bank, the force majeure took place and the beneficiary then drew on the letter of credit, in these circumstances, the drawing of the beneficiary could be treated as a fraudulent act and the beneficiary then could be considered a fraudster. In one American case, Harris Corp. v. Nat'l Iranian Radio & Television, the court decided that a force majeure clause in the underlying contract represents the beneficiary's commitment that it will not draw on the credit if the applicant's performance has been suspended or the contract has been terminated by an event of force majeure.

In Harris Corp. the 1979 revolution in Iran prevented the seller from shipping the goods as was required under the sales contract with the buyer. The contract contained a clause of termination in case of a force majeure. The court noted that the buyer's demand was a fraudulent one and as such granted a payment injuction.

To summarize, the action to be taken in case of a force majeure actually depends on the clauses (terms and conditions) of the contract and the bank's undertaking whether it is a standby LC or a bank guarantee. Sometimes the bank may be prevented from paying in force majeure circumstances. Under UCP600, Article 36 (Force Majeure) states that '[A] bank assumes no

liability or responsibility for the consequences arising out of the interruption of their business by Acts of God, riots, civil commotions, insurrections, wars or any other causes beyond their reasonable control'. The article continues to indemnify the banks from any responsibility or liability that may arise as a result of declining the beneficiary's drawing in the aftermath of the force majeure upon resumption of its business. As such, it is wise for a beneficiary of a transaction governed by the UCP600, to require an alteration of the provisions of Rule 36 whereby an automatic renewal clause is included therein. For example, the altered provisions may provide that the letter of credit will be extended for another 30 calendar days after the date at which the bank reopens for business. As we saw earlier, the ISP98 already includes this rule which is primarily meant to protect the beneficiary. (See Rule 3.14 (a) above).

4.14.2 The value of standby LCs or guarantees for construction projects

The usual norm is that banks who issue standby LC or guarantees securing the performance of a contractor in major construction projects bear total risk not exceeding 25 per cent of the construction contract value and regardless of the securities provided by the contractor for the bank; the securities are the bank's last line of defence. Albeit this is only a small proportion of the total value of the project, most of the time it provides full or almost full protection for the owner. Furthermore, the amount does not change the fact that performance LC or guarantees are the contractor's real driver for good performance.

We have previously explained that standby LC and bank guarantees constitute a huge financial risk on the applicant, who in this case is the contractor, since the standby is usually made available for the beneficiary against a simple demand and a draft both of which are under the full control of and prepared by the beneficiary. The bank is bound to honour the beneficiary's claim upon presenting these two documents in compliance with the stipulations of the instrument without having to investigate the fact presented by the claim beyond the face of the documents. If the beneficiary's claim is a fraudulent one, the contractor (applicant) can legally pursue the owner for compensation.

In one case, a standby LC was issued at the request of the contractor in favour of a project owner for USD7 million which represented 10 per cent of a $70 million value construction contract. The owner drew on the LC by presenting the required documents conforming to the LCs' stipulations and received payment from the bank. Although the contractor objected to honouring the presentation by the issuer, it was obliged to reimburse the latter for the full value paid in addition to due charges as the documents presented

under the standby were compliant. The contractor sued the beneficiary for the wrongful drawing on the standby LC since the contractor delivered the project in accordance with the construction contract specification and won the case thereafter, but did so after four years from the date it reimbursed the issuing bank. This example illustrates the huge financial risks on the contractor; payment of $7 million can cause severe financial problems to any company and can even cause insolvency. Contractors are always cautious to avoid situations whereby an owner would draw on the standby LC for a project. Moreover, the proceeds received when a project owner makes a demand on a credit are often sufficient to cover all-or a significant portion of the costs incurred by an owner in a default situation. This is true even when the guarantee is written for a fraction of the contract value. Consider the following example:

In one case a contractor commenced constructing a tower under a construction contract of $50 million. The owner made payment to the contractor gradually and in proportions according to the completed work in each of the phases of the projects. Upon completing 50 per cent of the work the contractor defaulted. The owner drew on the performance standby LC and managed to recoup more than 95 per cent of the costs incurred upon default.

The owner then entered into a new contract with another contractor who was in principle ready to finish the remaining 50 per cent of the project which was supposed to cost $25 million at this stage. The new contractor, nevertheless, will need more than the $25 million to complete the tower. This is because there are extra costs needed for assessing the status of the constructed portion of the project. Moreover, fixing existing defaults in the construction, changing the cadre of the team, purchasing extra material in addition to the extra charges levied by the new contractor in return for reviving the project would all add to the costs. So the cost in practice would reach $27 million and hence the new contractor would need to issue a new performance standby LC or bank guarantee for at least 5 per cent of this amount, that is, $1.35 million.

Occasionally however, a standby LC or a bank guarantee issued for a proportion of the value of the project may be insufficient to cover the damages suffered as a result of the contractor's default. It is essential for the owner to closely monitor the work progress during the different phases of the project in order to ensure that any deficiencies, problems or variations from the contract's specifications are properly and momentarily cured whilst the contractor is still at the site. If, however, problems can only be detected after the final testing of the project, and these problems are serious defections, the damages could have a value far exceeding that of the standby and may be unrecoverable.

CHAPTER 5

Examination of Documents

5.1 EXAMINATION FOR COMPLIANCE

Rule 4.01 of the ISP98

This rule clearly illustrates the principle duty of the issuer, confirmer or an authorized nominated person, that is, to honour the value of the standby upon presentation of the stipulated complying document(s) (demand and other document(s) if any). This means that the presentation must be checked against the terms and conditions of the standby supplemented by the provisions of ISP98 to determine conformity. The method of examining the documents differs according to the type of document in question; compliance of certain documents is dependent on its role in standby practice, whilst the text of other documents must correspond to that of the standby and in certain cases the text must be identical. Sometimes even a document that is merely not inconsistent with the standby would be considered a complying document (Rule 4.09 of the ISP98).

Subrule 4.01 (b) reiterates the major LC principle that the issuer's responsibility is limited to examining the documents on their face and has no duty whatsoever to investigate or inquire any fact represented by such documents beyond their face. Further, the rule affirms that the ISP98 provisions must be adhered to whenever the documents are under examination against the standby's terms and conditions. Once again, it is affirmed that the ISP98 provisions are supplementary to the standby text (read now the interpretation of Rule 1.03 of the ISP98). Hence, the examination is to be based solely on the documents presented.

It is useful to note that the term 'on its face' does not mean the face or the reverse of the document. It means that there is a method of examination of

documents under documentary credits which is peculiar to LCs practitioners and such method must be adhered to.

It is also important to note that strict compliance does not mean an oppressive perfectionism to the words of the credit. This result was endorsed in the case of Tesco Corp. v. Federal Deposit Insurance Corp. wherein the letter of credit called for 'drafts Drawn under the Bank of Clarksville Letter of Credit Number 105'. The draft presented stated 'drawn under Bank of Clarksville, Clarksville, Tennessee letter of credit No. 105'. The court found that despite the change of capital letter 'L' to small letter 'l' and the use of the word 'No.' instead of 'Number', and despite the addition of the words 'Clarksville, Tennessee' the presentation conformed.

Since the documents must be checked by the issuer, the confirmer or a nominated person authorized under the standby to honour the value of the presentation, each of these persons is responsible for making their own separate examination. When, for example, the nominated bank advises a discrepancy to the issuing bank, the latter relies on the advice at its own risk and is not thereby relieved from the responsibility of examining the documents by itself (read ISP98 Rule 5.05 (c) (ii)).

5.2 EXTRANEOUS DOCUMENTS

Rule 4.02 of the ISP98

Frequently, document checkers find in the presentations they check documents the submission of which is not required in the text of the standby. Rule 4.02 of the ISP98 call them 'Extraneous Documents' and stress that they need not be checked, but even if they were examined they must be disregarded at the time of making the decision regarding compliance of the presentation.

The rule also provides that extraneous documents may either be returned to the presenter or passed on with the other documents presented. In simple words, extraneous documents have no bearing whatsoever on determining whether or not the presentation is compliant.

The most well-known extraneous document is the covering letter that encloses the presentation (covering schedule). An extra set of documents presented at the request of a party to the LC such as the applicant, would be another example of extraneous documents. Sometimes the beneficiary unintentionally presents an extra copy of a stipulated document say four copies I/O 3; again such errors can not be considered as discrepancies and will not effect the process of checking documents.

The principle that the issuer pays only against the presentation of compliant documents stipulated by the standby constitutes the rationale behind of this rule.

5.3 INCONSISTENCIES

Rule 4.03 of the ISP98

This rule stresses that the documents presented must be consistent with the terms and conditions of the standby and need to be consistent with one another only to the extent provided in the standby, therefore, the documents checker can overlook any inconsistencies between the various documents presented in cases where the standby text does not necessitate the presentation of consistent documents.

Let's take an example, the following paragraph is a quotation from a standby LC issued by JP Morgan Chase:

> This standby is available by negotiation at sight against presentation to us of the following documents:
>
> Your sight draft drawn on JP Morgan Chase for the amount of your claim.
>
> Your certificate stating that you have made shipment of 30 cartons of Russian Crystal and have supplied the required documents to JSCS Trading Company and have not been paid within 25 days after the invoice date.
>
> Copy of unpaid invoice.
>
> Copy of the Marine Bill of Lading.
>
> Partial drawings are allowed.

You might have noticed that although the standby stipulated the presentation of copies of the invoice and marine bill of lading, it did not require the indication of anything other than they are an invoice and a marine bill of lading. If the beneficiary included with his claim for $50,000 – a copy of an invoice for $200,000 – together with other stipulated documents, the presentation would not be discrepant even though the invoice and the claim are inconsistent.

Accordingly, the ISP98 affirms that the only consistency at issue in examining documents under a standby is with respect to the stipulations of the standby itself. Of course the case is not so in commercial LC where all documents must be consistent with one another.

5.4 LANGUAGE OF DOCUMENTS

Rule 4.04 of the ISP98

The documents checker at the issuer's office will need to read and understand the whole content of the documents presented under the standby. For this reason, Rule 4.04 of the ISP obliges beneficiaries to present documents issued by them in the language of the standby.

Having said so, there are certain documents over which the beneficiary has no control, such as a Certificate of Origin issued by a governmental body in a non-English speaking country. These documents may be presented in any language. In such cases, the issuer can either translate the script of the document and thus bear the responsibility of the translation, or employ a checker who speaks the language in which the documents are presented.

You may have noticed that this rule is placed mainly for the operational convenience of the issuer, this means that the requirements of the rule may be waived without the need to obtain the consent of the applicant. It would be very useful here to revise Subrule 3.11 (b) (ii) of the ISP which we explained earlier.

5.5 ISSUER OF DOCUMENTS

Rule 4.05 of the ISP98

In commercial LC practice, most of the documents required are issued by parties other than the beneficiary. Nevertheless, the situation is different in standby LC as most of the documents stipulated are issued by the beneficiary. For this reason, the rule provides that required documents must be issued by the beneficiary unless the standby requires otherwise.

Naturally, If the standby states that the document is to be issued by a third person, it would be discrepant if it is issued by the beneficiary. Further, if the standby states that the document is to be issued by a third party, then it would be discrepant if it is not issued by that same party.

Some types of documents are normally expected to be issued by known parties, such as a governmental health certificate, a court order, an independent surveyor certificate or a post office receipt. These documents must

be issued by such expected parties even though the standby does not explicitly require said parties to issue such documents.

5.6 DATE OF DOCUMENTS

Rule 4.06 of the ISP98

This rule states two conditions regarding the date of the documents presented under a standby:

1. Documents issued prior to the issuance date of the standby are acceptable.
2. Documents bearing a date that follows the date of the presentation are NOT acceptable (Post Dated Documents). Banks seldom encounter situations where documents presented are dated after the date of the presentation and it is a normal practice to reject such documents; nevertheless, the legislator thought that it is more appropriate to have a definite rule embodying the practice rather than leaving the question in doubt. An example of a situation in which the beneficiaries present post dated documents is when the documents are presented under a direct pay standby before the maturity date whilst dating the documents on the scheduled date in attempting to obtain an early payment.

It is worthwhile noting here that unless the text of the standby prohibits the presentation of post dated documents, the issuer can, under Rule 3.11 (b) of the ISP98, waive the requirements of this rule without obtaining the applicant's consent.

5.7 REQUIRED SIGNATURE ON A DOCUMENT

Rule 4.07 of ISP98

This rule defines the situations at which a required document must be signed. It states that in general, a document need not be signed unless: (a) the standby stipulates otherwise or, (b) the document must be signed by law or by the ISP98 provisions such as a bill of exchange, the beneficiary's

statement of default or a demand for payment or, (c) the document is expected to be signed by standard standby practice, such as original marine bill of lading, multimodal transport document, legal documents and insurance documents.

As a general note, the standard LC practice – with regards to signature of the common documents presented under documentary credits – as embodied in the new UCP 600 Articles, requires the following:

1. Commercial Invoice (Article 18 – UCP 600), an invoice need not be signed.
2. Multimodal Transport Document (Article 19 – UCP 600) must be signed.
3. Marine Bill of Lading (Article 20 – UCP 600) must be signed.
4. Non-Negotiable Sea Waybill (Article 21 – UCP 600) must be signed
5. Charter Party Bill of Lading (Article 22 – UCP 600) must be signed
6. Air Transport Document (Article 23 – UCP 600) must be signed
7. Road, Rail, or Inland Waterway Transport Documents (Article 24 – UCP 600) must be signed.
8. Courier Receipt, Post Receipt or Certificate of Posting (Article 25 – UCP 600) must be stamped, signed or otherwise authenticated.
9. Insurance Document {Insurance Policy, Insurance Certificate, Declaration under Open Policy} and Coverage (Article 28 – UCP 600) must be signed.

Going back to Rule 1.09 (a) ISP98 Definitions, the signature includes any symbol executed or adopted by a person with a present intent to authenticate a document. Subrule 4.07 (b) – ISP98 puts it in simple words; the signature may be made in any manner that corresponds to the medium used for presenting the documents.

Under Subrule 4.07 (c) – ISP98 states that the signature need not indicate the name of the signatory unless of course the standby so specifies. The same applies to the status (designation) of the person who signs; if the standby is silent on the status of the person to sign, and then the status need not be shown.

Subrule 4.07 (d) – ISP98 clarifies that whenever the standby dictates that a signature must be made by a specified natural person without specifying his/her status, a signature conforms only if it appears on its face to be made by that same specified person but need not show the status of the

signatory. The rule used the words 'appear on its face' to stress that the examiner is not obliged to check the signature beyond the face of the document, that is, even if the signature is a forged one but appears to be genuine, the examiner bears no responsibility for the forgery as long as the signature appears to be that required by the standby. This of course does not apply to electronic signatures presented in situations depicted under Subrules 3.06 (b) (i) and 3.06 (b) (ii), where the document checker is obliged to check the authenticity of the document bearing the electronic signature (reread Subrule 3.11 (c)).

Subrule 4.07 (d) (ii) – ISP98 clarifies that where the standby requires that the signatory must be a legal person or a government agency without specifying who is to sign on its behalf, any signature that appears to have been made on behalf of the legal person or the government agency is acceptable.

Subrule 4.07 (d) (iii) – ISP98 provides that where the standby dictates that the signatory is to be a natural person, a legal person or a government entity and requires the status of the signer to be indicated, the signature complies when it appears to be that of the signatory required in the standby and also the signatory's status is indicated with the signature. The indication of the status need not be identical to the standby requirements, for example if the standby requested the status to be shown on a certain document is 'Financial Controller' and the document presented indicated two signatures one of which is 'Financial Controller' and the other is 'Chief Executive Officer', the signature is acceptable unless of course the standby stipulates otherwise.

5.8 DEMAND DOCUMENT IMPLIED

Rule 4.08 of the ISP98

Even though the standby is a documentary undertaking, there are times when the standby omits to stipulate the presentation of demand upon drawing on it. In such cases, this rule obliges the issuer to accept a demand presented by the beneficiary as a stipulated document, provided of course the demand complies with all the terms and conditions of the standby and the provisions of the ISP98.

In simpler words, in the event that an independent undertaking (standby) does not specify a required document, this rule provides that a demand document is required. The text of such demand document would be derived from Rule 4.16 and have to comply with Rule 4.17.

5.9 IDENTICAL WORDING AND QUOTATION MARKS

Rule 4.09 of the ISP98

In commercial LCs, and due to the larger number of documents required in a presentation, it is fairly difficult to produce a set of documents that mirrors the LC's text word by word. This leaves open the question of the extent to which the text of a presented document should match the text specified in the LC. The ideal approach to answer this question is examining the character of the document, the purpose for which it was issued and the acceptable level of compliance under standard banking practice.

In this regard, it is possible to derive from Subarticles 14 d and 18c in UCP600 a general principle for determining the needed level of similarity between a document's text and that of the LC. Subrule 14 (d) states that data in any document need not be identical but must not conflict with data in the same document, other documents or the credit. The degree of compliance here is lower than the degree of compliance required under Subarticle 18 c where the UCP dictates that the description of goods, services or performance in a commercial invoice must correspond with that appearing in the credit. Hence, it is possible to describe goods in all other documents in general terms not conflicting with the terms of the credit whilst in the commercial invoice the text describing the goods must correspond with that appearing in the credit.

Here the distinction between the required level of similarity of the document's texts and the LC's text is clear. It is mainly based on the nature and purpose of different stipulated documents. The description of the goods in commercial LCs is of significant importance, which is why the UCP stresses the necessity to describe the goods, services or performances in wording that correspond to the credit text. Nevertheless, the description of goods in other documents may appear in general terms depending on the commercial function of each document. The insurance document for instance is mainly focused on the risks pertaining to the safety of the goods during carriage rather than the description of the goods, therefore, it is adequate to describe the goods in general terms. The same applies for transport documents which are focused on the means of transporting the goods and the terms of such transportation rather than the description of goods.

Standby LCs often require the insertion of a specific statement in a stipulated document.

The extent to which the wordings of the statement need to be identical to the wording of the LC is determined by the LC itself and can be classified

under three distinctive cases:

A. Where the standby LC requires a document to contain a statement without specifying the precise wording of such statement, then even the document which contains a totally different wording is a compliant one if it appears to convey the same meaning. (This is the content of Subrule 4.09 (a)).

B. Where the standby specifies precise wording by the use of quotation marks, blocked wordings, or an attached exhibit or form, then typographical errors in spelling, punctuation, spacing, or the like that are apparent when read in context are not required to be duplicated and blank lines or spaces for data may be completed in any manner not inconsistent with the standby. Let's read the following two examples:

A statement in the standby text reads: 'we have shipped the goods but did not receive payment within 30 days from invoice date'. If the presented claim containing the same statement reads 'we have shepped the goods but didn't received payment within 30 days from invoice date', then the document is not discrepant despite the fact that neither its words nor its layout are identical to the standby LC text. Since the document's text correspond to the LC's text, it is a compliant one as in this case it need not be a mirror image or an exact duplicate of the specified wording.

Sometimes the document checker needs to use common sense in determining whether or not a wording in a document is compliant. In cases where the standby text itself contains typographical errors or meaningless statements, it would be absurd to blindly copy the text, furthermore, differences in spaces, capital/small letters, commas, or line placements need not be identical.

In general, typographical errors do not render the document discrepant unless they change the meaning of the document or statement and here the errors cease to be mere 'typographical errors' and the document becomes discrepant. (The content of Subrule 4.09 (b)).

C. Subrule (c) covers the situation where the standby LC requires a document to contain precise wording and also stipulates that the wording must be '*exact*' or '*identical*'. In this case the text of the LC must be 'slavishly imitated' that is the document must contain a mirror image of the text with wording, spaces, marks and line placements precisely identical to the standby LC's text regardless of any type of errors or omissions it contains.

Because of the practical difficulty of producing a mirror image text, great care must be exercised in both drafting the standby LC text and preparing the stipulated documents thereafter. This is because any difference here, no matter how minor or trivial it is, would render the document discrepant. For

example, if a standby letter of credit requires the text 'The northern part of the building, constructed by contractors should be delivered latest by DEC 2007' to appear in a certain document. Obviously the dotted lines here are meant to be replaced by (filled with) the contractor's name who constructed the northern apartment, but under this rule the document would be treated as a discrepant one and rejected by the bank if it contained the contractor's name since the document must slavishly imitate the LC's text.

5.10 APPLICANT APPROVAL

Rule 4.10 of the ISP98

In commercial LCs, banks continuously discourage the inclusion in the LC of conditions that require the presentation of a document on which the beneficiary has no control whatsoever. Such credits are often called *Inoperative Credits*. An example of an inoperative LC is a credit for importing eggs that stipulates the presentation of a document issued by the Ministry of Health in the importing country certifying that the imported cargo of eggs was inspected on the arriving vessel, found fit for human consumption and therefore allowed to enter the country.

In this example, the beneficiary will not receive payment under the LC unless it presents the stipulated documents including the Ministry of Health certificate, that is, the document on which it has no control. So if the beneficiary fully complies with the LC's stipulations but for some reason was unable to obtain the Ministry's certificate, it will not receive payment.

This type of LCs is normally discouraged by banks since it weakens the beneficiary's position under the LC.

A similar situation arises when applicants of standby LCs require that the beneficiary's presentation includes a document signed by the applicant himself to obtain payment. This means that the applicant controls the payment in all circumstances, which also means that the credit is not irrevocable nor is an ideal device to secure the beneficiary's interest.

Nevertheless, it is warranted in rare circumstances to include stipulations that can not be met without the applicant's approval. In the trade of certain types of food stuffs for example, the applicant would allow payment upon ensuring that the imported goods were received fresh in good time.

Rule 4.10 is merely an alert for the beneficiary that such requirement would not be generally equitable to it, however, it is up to the beneficiary to choose whether or not it will accept these terms. The rule also states that the issuer can not waive such requirements. Furthermore, it provides that the

issuer is not responsible in case the applicant refuses to cooperate by signing a document, delivering a document or arranging to comply with any other terms that are under its control in order to sanction payment.

5.11 NON-DOCUMENTARY CONDITIONS

Rule 4.11 of the ISP98

In commercial LCs, banks continuously discourage the inclusion in the LC of conditions that require the presentation of a document on which the beneficiary has no control whatsoever. Such credits are often called *Inoperative Credits*. An example of an inoperative LC is a credit for importing eggs that stipulates the presentation of a document issued by the Ministry of Health in the importing country certifying that the imported cargo of eggs was inspected on the arriving vessel, found fit for human consumption and therefore allowed to enter the country.

In this example, the beneficiary will not receive payment under the LC unless it presents the stipulated documents including the Ministry of Health certificate that is the document on which it has no control. So if the beneficiary fully complies with the LC's stipulations but for some reason was unable to obtain the Ministry's certificate, it will not receive payment.

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A similar situation arises when applicants of standby LCs require that the beneficiary's presentation includes a document signed by the applicant himself to obtain payment. This means that the applicant controls the payment in all circumstances, which also means that the credit is not irrevocable nor is an ideal device to secure the beneficiary's interest.

Nevertheless, it is warranted in rare circumstances to include stipulations that can not be met without the applicant's approval. In the trade of certain types of food stuffs for example, the applicant would allow payment upon ensuring that the imported goods were received fresh in good time.

Rule 4.10 is merely an alert for the beneficiary that such requirement would not be generally equitable to it, however, it is up to the beneficiary to choose whether or not it will accept these terms. The rule also states that the issuer can not waive such requirements. Furthermore, it provides that the issuer is not responsible in case the applicant refuses to cooperate by signing a document, delivering a document or arranging to comply with any other terms that are under its control in order to sanction payment.

Practical Issues: Albeit the principle of the non-documentary conditions, sometimes it becomes necessary to consider a non-documentary condition as a documentary one if it becomes possible to correlate the condition to another document that evidence its compliance. For instance, if the credit contained the condition 'goods must be of Italian origin'. This condition is obviously a non-documentary one; however, upon checking the documents, the checker found that both the Inspection Certificate and the Commercial Invoice presented under the same LC contained phrases certifying that the goods are of Italian origin. In this case, the non-documentary condition can be considered as a documentary one since there are acceptable documents to evidence the fact the beneficiary complied with this specific condition.

In practice, it is almost impossible not to be able to draft a documentary condition. The only reason for frequently running through such conditions is negligence. It is a known principle in banking that non-documentary conditions are totally disregarded. For example if the applicant, the buyer, wants the goods shipped on a Chinese ship, then it must require the beneficiary to provide a document issued by the carrier certifying that the vessel is registered in China.

5.12 FORMALITY OF STATEMENT IN DOCUMENTS

Rule 4.12 of the ISP98

The common practice under Standby LCs is that stipulated documents comply if they fulfil the LC stipulations, indicate a valid date and bear the beneficiary's signature. There is no need to add a formality to the document unless the standby letter of credit requires so. Normally standbys require the presentation of a simple claim and a draft solely prepared and signed by the beneficiary. The claim constitutes a statement indicating that a default situation – or other drawing event – has occurred and thereafter requesting payment.

The easiness at which beneficiaries can draw on a standby letter of credit makes it a high risk instrument and applicants therefore seek to take protective measures to ensure that drawings are only made when they are due. One of these measures is the inclusion of reminders within the wording of the beneficiary's claim that the claim is a legal document and if it contains any false certification the beneficiary could be legally questioned and would therefore bear the serious legal consequences; it is a sort of self deterrent. Furthermore, the law in certain countries penalizes for false statements

appearing in financial or commercial documents if they are attended by a degree of formality, thus, standbys are often drafted in such a way that allows invoking these legal protections. In essence, this rule directs the applicant to dictate the inclusion of any formalities in the text of the standby itself.

Subrule (b) provides for situations where the standby literally requires an addition of formality by the person presenting a statement without specifying the form or content. In such situations the statement complies if it indicates that it was declared, averred, warranted, attested, sworn under oath, affirmed, certified, or the like.

An addition of formality to a statement is called a *Solemnity* and it means adding words which proves that the person writing the statement is aware of the significance of its statement and the seriousness of including false details in it.

The use of any of the terms declared, averred, warranted, attested, sworn under oath, affirmed, certified, or the like in a standby is considered a requirement for a *statement of solemnity.*

Subrule (c) addresses the situation in which the standby requires a statement to be witnessed by another person without specifying form or content, the statement complies if it appears to contain a signature of a person other than the beneficiary with an indication that the person is acting as a witness and certifies the statement and the signature of the beneficiary or the principal who prepared the original statement.

Subrule (d) is in essence equal to paragraph 4 of Article 3 of the UCP600 and it addresses the situation where the standby requires the document to be *Officialized*. This means that the statement must be countersigned by an official body. In this case the requirement is satisfied by any signature, mark, stamp or label on the document which appears to be for a person other than the beneficiary indicating the person's capacity and the name of the principle on whose behalf the person is acting. However, if the standby specifies the name of the official body that must *Officialize* the statement, that is, the organization, chamber, ministry, court … etc., then the statement must clearly indicate the same name in addition to the name of the official signing and its capacity. A notarized statement falls within this type of authorization.

5.13 NO RESPONSIBILITY TO IDENTIFY THE BENEFICIARY

Rule 4.13 of the ISP98

Upon drawing on the standby LC, the beneficiary mostly requires payment to be made to a bank account specified in the claim or the covering

schedule/letter of the presentation. Sometimes, the beneficiary assigns the proceeds of the standby to a third person and requires that payment be made in whole or in part to the assignee.

Whenever an electronic presentation under a standby is allowed or permitted, the issuer, nominated person or the confirmer is bound to check the authenticity of the electronic presentation made to ascertain the identity of the sender (presenter). The case is not so whenever the presentation is made in a medium other than an electronic one.

Usually documents are presented to the nominated, confirming or issuing bank by an unknown person whose identity and capacity can seldom be ascertained by the bank. In fact, this rule clearly states that the bank (represented by its document checker/examiner) is under no obligation to ascertain the identity or capacity of the presenter.

Subrule (a) merely clarifies that where a presented drawing is a fraudulent one and the bank pays the funds to a party who is not the genuine beneficiary or assignee but an impostor villain, the applicant bears the full responsibility and the bank is not liable in this case. The applicant is responsible for the wrongful payment and is also bound to honour the drawing of the genuine beneficiary whenever it is made. However, if the applicant becomes insolvent, the issuer in this case bears the full responsibility.

Subrule (b) indicates that the issuer fulfils its obligation once it makes payment to the person entitled to it under the standby, namely the specified beneficiary, the transferee or any other person who may become eligible to claim the standby proceeds by law or by assignment of proceeds. Payments can also be made by internal transfers in bank accounts or assignment of proceeds requests. This means that the issuer also fulfils its obligation when it abides with the beneficiary's instructions or the nominated bank's instructions and makes payment to a bank or account number.

5.14 NAME OF ACQUIRED OR MERGED ISSUER OR CONFIRMER

Rule 4.14 of the ISP98

For many reasons, an issuer or confirmer may change its name after issuing or confirming a standby, for example, in cases of a brand change, direct name change, acquisition, or merger.

Eventually, this could lead to operational problems causing to halt payment if the beneficiary presented documents using the former name of the issuer or confirmer. To avoid such situations, this rule allows the beneficiary to any of

the names whether the current or the former and obliges the issuer or confirmer to accept the presentation provided of course it is in all respects compliant with the standby terms and conditions and the ISP98 requirements.

5.15 NAME OF ACQUIRED OR MERGED ISSUER OR CONFIRMER

Rule 4.15 of the ISP98

In commercial LC, Article 17 of the UCP600 (Original Documents and Copies) requires the presentation of at least one original document. Similarly, Subrule 4.15 (a) of the ISP98 provides that any presented document must be an original unless a standby stipulates otherwise.

In LC operations, document checkers cautiously examine documents to determine whether they appear on their face to be originals or copies. In commercial LC, examiners are not concerned with determining if the apparent original is the only original issued except in cases depicted by the following Articles in UCP600:

i. 19 a (iv)
ii. 20 a (iv)
iii. 21 a (iv)
iv. 22 a (iv)
v. 23 a (v)
vi. 24 b

Subrule 4.15 (b), a supplement of Rule 1.09 (c), provides that where an electronic presentation is made, banks must treat it as an original.

Subrule 4.15 (c) of the ISP98 clarifies the meaning of the term 'Original' in the context of LC operations. It provides that a document is assumed to be an original one unless it appears not to be so. In this respect, banks depend on the apparent intention of the issuer to decide; if the issuer of the document intended it to be an original one, then it is considered as such, for example, a person who prints out a file saved on his lap top is assumed to have intended to produce an original copy. Conversely the document will be treated as a copy if the issuer intended to produce a copy, for example, someone sending a fax, or photocopying a document or making a carbon

copy is presumably intending to produce a copy and not an original, and hence any of these documents will be treated by the bank as a copy.

Nevertheless, if a document appears to have been reproduced from an original, it will be treated as an original if it appears to contain any original authentication (signature, stamp, mark … etc.). Thus if any copy in our previous example was signed as original, it will be considered as such.

Banks are not responsible for checking whether a document is genuinely original. A forged document that appears to be an original one does not place the bank under any liability. The presentation of forged and fraudulent documents is left for the law to handle.

Subrule 4.15 (d) provides that under a standby which stipulates the presentation of a copy, the beneficiary is allowed to present either a copy or an original. If, however, the standby stipulates that only a copy may be presented, then the document required must be presented as a copy. Further, if the standby addresses the disposition of all originals then a copy of the document must be presented. For example, if the standby requires that the original bill of lading must be forwarded directly to the applicant, a certification to this effect must be made by wording added to a copy of the bill of lading that must be presented with any drawing under the standby. Then obviously the presentation of the original bill of lading would be a discrepancy.

A copy is defined as any document that is not an original. Banks treat as a copy the following:

a. Any document that appears to be a photocopy of another document. In this regards, a document photocopied on original headed paper is not considered a copy. Also a photocopy that is marked or signed by handwriting or bears an original stamp is not considered as a photocopy.

b. A document sent by fax is treated as a copy.

c. A document containing word indicating that it is a copy.

d. Carbon copies or Stencil.

Subrule (e) states that where the standby requires presentation of multiples of a document, it is mandatory to present at least one original, unless:

i. ‘duplicate originals’ or ‘multiple original’ are requested in which case all must be originals; or

ii. ‘two-copies’, ‘two-fold’, or the like are requested in which case either originals or copies may be presented.

Hence, the term ‘original in five copies’ means that one must be presented as an original and the remaining four documents may be presented as either originals or copies.

Subrule (e) (i) provides that whenever the standby requires that all presented documents must be originals, then the terms 'duplicate originals' or 'multiple originals' must be used.

A standby that requires 'four originals' or the like also stipulates the presentation of originals only.

Subrule (e) (ii) indicates that terms such as 'two-copies' or 'two-fold' mean that all the multiples may be presented in copies or originals and the beneficiary need not present originals.

5.16 STANDBY DOCUMENT TYPES – DEMAND FOR PAYMENT

Rule 4.16 of the ISP98

Rule 4.16 provides that a demand for payment under a standby need not be in a separate document and could be embodied in any other stipulated document unless the standby *expressly* dictates the presentation of a demand for payment in a separate document. For example in a standby that requires a demand and a statement of default, a presentation of the statement of default would be adequate to honour the beneficiary's claim as the bank considers the default statement as an implicit demand for payment. In any case, a default statement must always fulfil the provision of Rule 4.16 and Rule 4.17 of the ISP98.

In any case, the beneficiary can always present a separate demand document. This is true even if the standby does not stipulate a separate one.

Subrule (b) specifies the details that must be contained in a demand required by the standby to be presented as a separate document. The demand need to (a) expressly request payment from the issuer or nominated person, (b) contain a date indicating when the demand was issued, (c) specify the amount demanded and, (d) contain the beneficiary's signature.

There is no specific formula or wording to write a demand, a demand can be drafted in any form that indicates a request for payment regardless of the vocabulary. The demand also need not be titled, named or labelled 'Demand'. So, for example, the words 'please pay' or 'pay me' or 'honour this claim' or any similar phrases also connotes a demand. If the issuer or applicant requires precise wording in the demand, this should be specified in the text of the standby.

Whatever details the standby stipulates beyond those stated in this rule, must be fulfilled in addition to the rule's requirements since the ISP

provisions supplement the text of the standby. For example, if the standby requires a demand presented separately and countersigned by 'Ministry of Industry', the demand must then contain the Ministry's counter signature and the specificities of Subrule (b), that is, date, amount, demand and signature of the beneficiary.

Subrule (c), provides that a draft, or other instruction or order or request to pay constitutes a demand. In other words, the draft is not necessary to present a valid demand.

Even if the standby requires the presentation of a draft or a bill of exchange, the draft or the bill of exchange need not be in negotiable form unless the standby so states.

5.17 STATEMENT OF DEFAULT OR OTHER DRAWING EVENT

Rule 4.17 of the ISP98

In general, a standby letter of credit is a legal promise (undertaking), made by a bank (issuer) on behalf of one of its customers (applicant), to pay on demand a fixed sum of money, in parts or in whole, to a named beneficiary if and when the applicant fails to carry out a certain duty he owes to the beneficiary (defaults). In other words, a bank that issues a standby letter of credit guarantees to cover the beneficiary for losses incurred as a result of the failure of the applicant to perform his part of an agreement with the beneficiary (failure to perform one's part in an underlying stand by agreement is normally referred to as a default situation). For the bank to do so, that is, to cover/pay the beneficiary in accordance with the standby terms, it requires the beneficiary to present a statement indicating that the applicant has defaulted and that payment is now requested and is due. This statement is called a statement of default.

Over the years, the standby LC have evolved to cover a much wider range of uses other than the default situation. It can be used for commercial purposes, insurance purposes and as a direct pay financial instrument, that is, an undertaking that allows the beneficiary to receive payment against a mere request. Direct pay standbys are normally used to pay the principal and interest of certificates of deposits and other investment tools. Whenever the standby is used for purposes other than a default situation, we say that the demand covers a drawing event.

Subrule (a) indicates that the payment statement, whether for a default situation or any other drawing event, must contain in addition to any other

requirements in the standby, the following:

1. A phrase stating that payment is due because the drawing event described in the standby has occurred.
2. A date of issuance.
3. The beneficiary's signature.

As mentioned above, this rule supplements the text of the standby where it called for data beyond that required in the rule. Thus if the standby requires a statement that 'the beneficiary has shipped the required goods and was not paid within 30 days from invoice date' the standby need not stipulate that the statement must be dated and signed by the beneficiary.

5.18 NEGOTIABLE DOCUMENTS

Rule 4.18 of the ISP98

Standbys frequently stipulate the presentation of a financial document of which some are negotiable like promissory notes, bills of exchange/drafts or investment bonds/certificates … etc. Since these documents are negotiable, their ownership may be transferred by endorsement and delivery if issued to the order of a specific person or by mere delivery if issued payable to bearer.

This rule clarifies that whenever the standby requires the presentation of a financial negotiable document without stating the specificities of the endorsement, that is, whether, how or to whom the endorsement must be made, then an unendorsed, a blankly endorsed, a specially endorsed or a restrictively endorsed document would be acceptable.

The negotiable document may be issued or negotiated with or without recourse depending on the governing laws.

5.19 LEGAL OR JUDICIAL DOCUMENTS

Rule 4.19 of the ISP98

In cases where the standby requires the presentation of formal documents issued by the government, a court order, an arbitration award or similar

formal documents, such documents must appear to be issued by an official representing the body stated in the standby. They must also appear to be signed, dated, suitably titled and finally the document must either be an original one or an originally certified or authorized copy but not a plain copy. This is because originals of such documents are often not released.

The documents' checker need not examine the content of the document to determine its effectiveness. The rule clarifies that that the document is acceptable if it appears to be suitably titled or named, issued by the party stipulated in the standby, signed, dated and certified as appropriate.

Same as all other Rules of the ISP98, this rule supplements the text of the standby. This means that any additional data called for by the standby must be provided in addition to the data required in the rule even though the standby does not specifically state the points required by the rule. For example if the standby requires the presentation of a document of title issued by the 'Department of Land and Property indicating the national number of the owner' it need not mention that the document must be appropriately titled, signed, dated and appear to be issued by the Department of Land and Property.

5.20 OTHER DOCUMENTS

Rule 4.20 of the ISP98

This rule provides that where a standby does not specify the required data content or the issuer for a stipulated document, the document complies if it appears to be the document required or if its content appears to fulfil the function of the required document under standby practice.

Subrule (b) states that the documents presented under standby LCs need not be consistent with other documents except to the extent provided by the standby itself. This is different from the provisions of Article 14 (d) of UCP600 where data in a document must not conflict with data in the same document, other documents, or the credit. Furthermore, the examination of commercial documents under the ISP98 is significantly different than checking these under the UCP, the most obvious example is the fixed period requirements of 21 days in Article 14 (c) of the UCP600 which is irrelevant under the ISP98. Also the provisions of Article 18 (i) of the UCP600 require that commercial invoices be issued in the name of the beneficiary. This may not be applicable under standby LCs where the beneficiary may well be someone other than the seller, for example, in cases where a beneficiary is a bank financier. Hence, this requirement also can not be fit for standby practice.

5.21 REQUEST TO ISSUE SEPARATE UNDERTAKING

Rule 4.21 of the ISP98

Suppose that the international firm J. Sifri Consulting Services (JSCS) wants to establish its operations in the Middle East and they decided to construct a modern premises for their headquarters in Amman. They requested Rasha Contracting plc to construct the new building. The contractor agreed to do so provided they receive a bank guarantee or a standby letter of credit from a reputable bank undertaking to cover the value of the contract if the JSCS did not pay for any reason. As such, JSCS asked their bankers JNB to issue the required guarantee. JNB agreed to do so on the condition that they obtain an adequate security. JSCS called their bankers, UBS in Switzerland, and asked them to issue a standby letter of credit (COUNTER STANDBY) in favour of JNB – Amman as means of security for JNB's local guarantee in favour of Rasha Contracting plc. UBS issued the counter standby LC in favour of JNB who in turn issued the local guarantee in favour of the building contractor Rasha Contracting plc and thereafter the new headquarter of JSCS was successfully constructed on time.

In order to issue a bank guarantee, standby LC or a confirmation undertaking, banks always require the provision of an adequate collateral security. A counter standby LC or a confirmation of a guarantee are only few examples of collateral securities normally accepted by banks for extending direct or indirect facilities.

Rule 4.21 of the ISP98 affirms that the counter standby and the other standby are two separate undertakings totally independent from each other regardless whether or not the counter standby recited, attached or indicated in any way the text of the other standby.

Subrule (a) states that the beneficiary of the counter standby receives no rights other than the rights conferred to him by the counter standby, that is, to draw under the standby itself, regardless of whether or not the beneficiary received a fee from the issuer for issuing the local standby. This subrule in essence is a confirmation that the two undertakings are separate and independent and they remain so even if the issuer of the counter standby has paid a fee for the beneficiary to issue the local standby.

For the same reason, Subrule (b) clarifies that document(s) presented under the local standby upon drawing need not be presented by the issuer of the local standby (also called the separate undertaking), that is, the beneficiary of the counter standby whenever the latter draws on the counter standby. Usually, the beneficiary of the counter standby draws on it by

presenting a statement of default or sending a tested telex stating that it has honoured a drawing under the separate undertaking. The separate undertaking (local standby LC) on the other hand, normally requires a statement or a claim from its beneficiary (counterparty to the underlying transaction). In this regard, it is useful to remember that no matter what are the documents the separate undertaking requires to be presented, these documents need not be represented when the issuer of the local or separate undertaking draws by presenting its claim to the issuer of the counter standby LC.

Subrule (c) clarifies that even if the beneficiary of the counter standby LC presented to the issuer the documents previously presented by the counterparty of the underlying transaction upon drawing on the local standby/separate undertaking, the issuer may disregard these documents and may return them without responsibility to the presenter or the applicant. In essence, such documents are extraneous and the issuer is free to disregard them under the principle stated in Rule 4.02 titled Non-Examination of Extraneous Documents. This rule simply clarifies that the issuer is under no duty whatsoever to examine such extraneous documents and it may dispose of them in any suitable way.

5.21.1 Counter standby LCs and guarantees covering performance

5.21.1.1 Counter performance standby LC

Under no circumstances would a bank issue any sort of undertaking without proper security. Even securities in banking represent the last line of defence; banks frequently decline applications for credit lines secured fully by lien over deposits amounting to more than 200 per cent of the transaction. It is the reputation of the customer in the trade circle, the management of the business at hand and the financial position of the applicant that banks are cautious about whenever they evaluate a new relationship or review an existing one.

Banks frequently receive applications from their correspondents (these are banks dealing with each other in accordance with special terms called agency arrangement) on behalf of an international contractor for the issuance of a performance standby LC or a performance guarantee, in favour of a local project owner by which they undertake to pay the value of the standby LC to the contractor responsible for constructing a building in the same host country at which the requested bank is located.

The local bank, upon reviewing its position with the correspondent bank who made the request and after evaluating the risks of the transaction, may agree to issue the standby LC provided the correspondent bank first issues

or arranges for the issuance of another standby LC or guarantee in favour of the local bank itself by which the correspondent bank undertakes to honour the claim of the local bank in reimbursement for any amount the latter paid under the counter standby LC or guarantee that it issued in favour of the local project owner pursuant to the correspondent bank's request.

Of course the local bank does not necessarily have to issue a counter standby LC at the request of a correspondent bank only, it may elect to do so upon the request of a non-correspondent provided that it satisfies itself as to the financial position and reputation of the bank. For example a request from banks like the Bank of Tokyo Mitsubishi, CitiBank, the HSBC, Deutsche Bank or Commerzbank would normally be good application regardless of whether or not any of them is a correspondent bank. For simplification purposes, however, we will only consider the case of receiving an application from a correspondent bank.

After the local bank in the host country assures itself that it is now properly protected after receiving in its favour a standby letter of credit or a bank guarantee from the correspondent bank by which the latter undertakes to honour the claim of the former for the value available under the standby plus any due fees or charges, it, the local bank, will then issue a separate counter standby LC or counter guarantee on behalf of the foreign contractor in favour of the project owner as beneficiary. If the project owner draws on the guarantee from the local bank, the local bank will in turn draw on the guarantee issued in its favour by the correspondent bank. The performance guarantee or standby letter of credit issued by the contractor's international bank stands in place of the credit of the foreign contractor.

McCormack v. Citibank, N.A. is an example of the practical difficulties a banker may face with counter – standby LCs and guarantees issued to guarantee performance of contractors. Notice that the two instruments are practically and legally identical when issued in connection with a performance undertaking, hence, what applies to one instrument applies to the other, this is only true for the performance type of undertakings. The distinctive features of each instrument where discussed earlier in Chapter 2.

'Acoustical Engineering, Inc., an American Company, entered into a construction contract with a Saudi Arabian corporation herein after called Obaid to assist in completing the construction of Riyadh International Airport in Saudi Arabia. By virtue of their agreement, Acoustical instructed their bankers 'The Saudi American Bank' – SAMBA, a subsidiary of the giant Citibank, to issue a performance guarantee in favour of Obaid, undertaking to pay Obaid's claim if Acoustical fails to deliver (defaults) the repair work as per the contract between them. In addition, the application letter contained an inoperable term to be incorporated in the text of the guarantee

stating that Obaid is allowed to draw on the guarantee only if they present a Certificate of Completion of the Works. (see Inoperable Credit 12.03 – Chapter 12).'

The transaction involved the issuance of three counter guarantees in addition to the final one in favour of Obaid by a total of four banks. The guarantee was eventually drawn on by Obaid whose claim was honoured by the SAMBA even though Obaid did not present the Certificate of Completion of Works. Consequently, each of the intermediary banks in turn honoured their respective undertaking to reimburse the next bank in the chain while the final bank reimbursed itself from the applicant Acoustical.

Upon detecting the debit to its account, Acoustical timely objected to SAMBA believing that they had wrongfully honoured Obaid's claim but SAMBA refused to assert the objection. Acoustical then sued SAMBA but the complaint was dismissed on jurisdictional grounds. Acoustical, then sued the other banks in the chain.

Acoustical argued that Obaid was only entitled to payment if it presented the documents stipulated by the guarantee whilst ensuring that these documents are fully compliant with the terms and conditions stated there in. Accordingly, Obaid's claim should not have been honoured because it didn't present the completioncertificate that was stipulated by the guarantee. As such, none of the intermediary banks should have paid under the same transaction.

The court rejected this argument on the ground that the text of the counter standby LC issued by Citibank included the following wordings which literally depicted the bank's undertaking: 'we the undersigned, hereby irrevocably and unconditionally confirm that upon receipt of your [SAMBA's] first written demand, we will pay you the amount demanded not exceeding the limit set forth herein'. 'The court found that since the Citibank letter of credit did not indicate that the Certificate of Completion need to be presented with the SAMBA's claim, the claim was a complying one and the Citibank were not liable for honouring it'. Similarly, the court's ruling applied to the two intermediary banks in the chain who also paid against simple demands.

This case effectively illustrates the legal risks facing a construction contractor required to arrange for the issuance of a guarantee from a bank in a foreign country. SAMBA's counter undertaking was secured by Citibank's clean standby letter of credit in the former's favour. Acoustical, on the other hand, was unprotected when Obaid's demand was honoured for payment. Because of the clean nature of those credits Acoustical had no recourse against the other intermediary banks in the chain.

Of course the situation would have been reversed had this case taken place in the United States of America instead of Saudi Arabia for example. This is because the American court would have found the bank obliged to

request the stipulated Certificate of Completion prior to honouring the beneficiary's demand. Acoustical lost the case merely on jurisdictional grounds. Alternatively, Acoustical could have easily won the case had they requested that all banks in the chain must honour a complying presentation only if it also included the Certificate of Work Completion.

CHAPTER 6

Notice, Preclusion and Disposition of Documents

6.1 TIMELY NOTICE OF DISHONOUR

Rule 5.01 of the ISP98

The beneficiary draws on the standby LC by presenting the required documents to the issuer, nominated bank or confirming bank if any. The concerned bank in turn examines the documents to ensure that they comply with the standby stipulations and effect payment thereafter. If, however, the examination reveals discrepancies in the presentation, the bank will halt payment and advise the beneficiary/presenter of the discrepancies so that it can take appropriate action to protect its rights. The bank responsible for checking the documents is obliged to issue to the beneficiary/presenter a *notice of discrepancies* otherwise such banks will bear the responsibility of the presentation, that is, it becomes liable to pay the value of the documents in spite of the discrepancies contained therein. This practice is stressed in Rule 5.03 of the ISP98 and also in Subarticle 16 (f) of the UCP600 where both rules confirm the duty of the issuer, a nominated bank acting on its nomination and the confirming bank if any to give the presenter a notice of discrepancies in good time. Nevertheless, there is an obvious difference between the approaches of both the ISP98 and UCP600 in determining the good time in which the concerned bank is compelled to give the notice of discrepancies.

The ISP98 differs in that it takes into consideration a host of factors other than the process of examining documents; Rule 5 acknowledges the full

procedure for handling a presentation that is from the moment the presentation is received by the bank, through the process of recording it and then forwarding it to the document's checking department, ending in checking the documents against the LC's text and giving notice of discrepancies or otherwise honouring the presentation. Normally documents presented for Small and Medium Enterprises (SME's) are processed on a 'first in, first out basis' and documents presented for corporates are treated as a priority. The pace with which the documents are presented depends on several factors such as the number of staff available for checking documents (vacations, recruitment, absences), work load … etc. Hence, seldom does a bank have document checkers ready to check the documents immediately upon receipt regardless of other obligations whether personal or professional. As such, the provisions of Subrule 5 (a) (iv) of ISP98 clearly state that the bank is under no obligation whatsoever to expedite an examination unless the standby expressly states that payment will be made within a curtailed period.

The procedure for examining documents begins with correlating the presentation with its standby properly updated with all valid amendments. This takes us back to Subrule 3.03 which highlights that failure of the beneficiary to identify the standby under which the presentation is made will cause delays in processing the presentation. Depending on the efficiency of the bank staff and the filing/archiving system of the bank, the standby file may be fetched on the same day or the second day following receipt by the examination department. In cases of mergers and acquisitions, the file may need to be brought from a different location and this would take more time. Once the file is fetched, the document examiner will have to update the original text of the standby with all subsequently accepted amendments, since Subrule 2.06 (c) (i) provides that the beneficiary must consent to all amendments in a standby LC. Once this is done, the documents checker starts checking documents to determine the course of action to be taken by the bank. As means of internal controls, banks normally assign their staff with different limits of authorities to check documents, for example, a presentation with a value of $5000 may be examined by one clerk whilst documents for $100,000 can only be honoured if they were examined by a clerk and a supervisor or a higher authority. These types of internal regulations are normally kept in the bank's departmental instruction manual and the regulations almost always vary from one bank to another.

Examining documents within three banking days following the banking day of receipt: Hence, the bank needs time to examine the documents and determine the course of action that follows the examination. Strictly from a banking operations perspective, it may not be useful for a document examiner to indulge himself/herself in studying legal concepts such as 'reasonable', 'unreasonable', 'reasonable man', 'reasonable standby practitioner,

reasonable time' or the like. It is adequate for the LCs practitioner to understand that Subrule 5 (a) (i) treats examining documents within three banking days following the banking day of receipt as the safe harbour period for banks.

Examining documents within 4–7 banking days following the banking day of receipt: If the document examiner takes more than three banking days following the banking day of receipt but less than seven banking days, it must be determined whether or not the time taken is unreasonable. To determine whether the time taken for checking a presentation is unreasonable, several factors are taken into considerations, specifically the complexity and size of the presentation, the number of staff needed to check it and other circumstances that arise during the checking process. This seven days time-span may be reasonable for checking the presentation if, for example, there is a large back log of work accumulated after a long holiday or if it was difficult to fetch the standby LC file from the filing room due to a failure of the electricity circuit of the security system on the door or any other unusual circumstances.

How long is an unreasonable time? Giving a notice of dishonour after seven days following the date of receipt of documents is definitely an unreasonable time and a bank that gives such a notice will be precluded from rejecting documents because of discrepancies and becomes obliged to take up said documents.

Subrule (a) (ii) states that even if the standby expires during the period of time allowed for examining the documents under this rule, the document checker will not be deprived from the time period remaining for him to complete the examination process, that is, whether the time within which notice is given is unreasonable does not depend upon an imminent deadline for presentation. Until the standby file is fetched and the amendments properly updated (in addition to the renewal/non-renewable-notices in the case of automatic renewal), the document checker will often be unaware of the fact that the standby LC is about to expire and regardless of whether or not the beneficiary advised him of the expiry date, the document checker is not obliged to expedite the examination process. If the checker detects discrepancies in documents and returns it back to the presenter to correct the discrepancies and represent the documents cured, the examiner will treat the presentation as a new one and will consider the date at which the corrected documents were received as the actual date of presentation so that if such date is after the expiry date the documents will be treated as non-conforming with a late presentation discrepancy; the onus of submitting compliant documents to the bank is the sheer responsibility of the presenter/beneficiary.

Subrule (a) (iv) clarifies that the case would be different if the standby specifically stipulates that the examiner must give a notice of discrepancy within a shortened time. In such a case the examiner is obliged to accelerate the examination process. A question that may arise here is what if the standby stipulates that the notice of discrepancy must be given within two banking days after the banking day of receipt of the documents? Here the ISP98 unfairly places the bank under the burden of examining documents within unreasonable time from the bank's perspective. In such circumstances, it would be safer for the bank to request an amendment to such a stipulation immediately upon receipt of the standby LC or else reject issuing/advising it.

Subrule (a) (iii) indicates that calculation of time for issuing a notice of dishonour begins on the business day following the date of receipt of the presentation. For a nominated bank acting upon it nomination that has forwarded documents to the issuing bank or confirming bank in another country, the calculation of time is possible by tracking the date at which the parcel containing the documents was received by the issuer; this could be done either online or by directly asking the courier that delivered the parcel about the date of receipt by the issuer. On the subject of time calculation, it is necessary to read Subrule 1.09 (a) (Definitions) and Subrule 9.03 (a) (Calculation of Time).

Subrule (b) (i) provides that the notice of dishonour must be given by telecommunication or similarly prompt means. Telecommunication means any method of transmitting or receiving signals/messages by an *electromagnetic* system (tele: Far off + Communication), that is, a notice of dishonour must be given by SWIFT., telefax, telex or telephone. If it is not possible to send the notice by telecommunication, then it must be sent by other available prompt means such as courier services.

Subrule (b) (ii) defines the concept 'prompt means' which was used in (b) (i) above as a method capable of delivering the notice of dishonour within the time allowed for giving such notice.

Subrule (c) provides that the bank must give the notice of dishonour to the presenter from whom the documents were received except where the standby stipulates that the notice must be given to any other party or except where the presenter itself requires that the notice be given to any other party. It is essential here to note that the examiner may or may not abide with the instructions of the presenter which are normally maintained in the covering schedule of the presentation at hand; Rule 5.08 (Cover Instruction/ Transmittal Letter) so states.

Whilst on the subject of handling discrepant documents, it is appropriate to note that Rule 5.06 permits the issuer to approach the applicant directly without the beneficiary's permission, seeking a waiver of discrepancies. If it elects to do so, the time within which the notice of discrepancies (dishonour)

must be given will not be extended. It is also essential to read Rule 5.05 (Issuer Request for Applicant Waiver without Request by Presenter).

6.2 STATEMENT OF GROUNDS FOR DISHONOUR

Rule 5.02 of the ISP98

This rule is similar to Subarticle 16 (c) (ii) of the UCP600 which provides that the notice of dishonour must state each discrepancy in respect of which the bank refuses to honour or negotiate. The rationale behind this rule is to prevent the examiner from stating some of the discrepancies and then raising the remaining discrepancies upon representing the same documents after correcting the first discrepancies identified. Inextricably linked to Rule 5.03 (Failure to Give Timely Notice of Dishonour), the two rules prohibit the practice of stating discrepancies at different times for the same presentation; the examiner must peruse the presentation and state every discrepancy in the documents when first presented or be precluded from raising the discrepancy upon representation. For example, if the bank has only three days to check the documents and determine whether or not they are compliant, and the document checker finds that the presentation is a discrepant one but advises the presenter on the fourth day of the discrepancy, the presentation will be treated as a compliant one and the presenter has every right to recover payment even though the presentation is discrepant. This is because the examiner must give a notice of dishonour in good time, that is, within the time-span specified in the standby LC or these rules, otherwise he/she will be prevented from claiming that the documents are discrepant and thus his/her bank bears the consequences. To reiterate, the examination of any presentation under a letter of credit must be made solely on the documents presented and an examiner is not in any way required to search beyond the face of the documents to determine compliance. This is because of the documentary nature of the standby LCs (Rule 1.06 (d)).

Rule 5.02 provides that the document checker must state all discrepancies in the notice of dishonour. Although the rule does not state how detailed a notice needs to be, it is a general practice amongst banks to state the discrepancies in short but incisive phrases, for example, a notice containing any or all of the discrepancies ‘late presentation’, ‘LC overdrawn’, ‘unsigned demand’ adequately states the reason for dishonour as required by this rule.

The bank that receives a presentation under a standby LC after the expiry date, is not obliged to give a notice of discrepancy even though it halts

payment for that reason, that is, credit expired. This is what Rule 5.04 provides for.

6.2.1 Overdrawn demands

Obviously a demand requesting payment for more than the amount available under the standby LC is a discrepant one and the presentation containing it would not be honoured (Rule 3.08 (e) (Partial Drawing, Multiple Presentations; Amount of Drawings)). This point is brought up here to denote that even if a demand is overdrawn and the bank dishonours it for this reason but fails to give a timely notice of dishonour, Rule 5.03 operates only for the amount available under the standby and not for the amount in excess of it. For example, a standby LC available by sight payment for only $20,000 – allows a total drawing (s) of $20,000. If the beneficiary presented a demand for $25,000 – and the examiner spotted that the demand is overdrawn, but failed to give the notice of dishonour within the periods required by Rule 5.03, the bank does not become obliged to pay the $25,000, rather is must only honour the available sum, that is, $20,000.

6.3 FAILURE TO GIVE TIMELY NOTICE OF DISHONOUR

Rule 5.03 of the ISP98

Upon receiving the set of documents presented under a standby LC, the document checker is obliged to check the presentation against the text of the LC and the provisions of the ISP98 in order to decide whether or not the documents are compliant and give the presenter a notice of dishonour thereafter. The examiner must do so in a timely manner, that is, within the specific periods set in Rule 5.01 or the text of the standby LC if it modified the periods for presenting and/or examining documents. The examiner must also give a notice of dishonour stating all the discrepancies spotted in the presentation since this is what Subrule 5.02 requires.

Subrule 5.03 indicates the consequences of failure to give a notice of dishonour that abides with the provisions of Subrules 5.01 and 5.02 of the ISP98. It is consistent with Subarticle 16 (c) (i & ii) of the UCP600 which states that when a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank decides to refuse to honour or negotiate, it must give a notice of discrepancies stating that the bank refuses to honour or negotiate and indicating each discrepancy in respect of which the bank

refuses to do so. Once again checking a presentation under a standby LC must be based solely on examining the documents on their face. Further, the document checker must not omit any discrepancy and then raise it later upon representation of the same documents cured. This is because the beneficiary is often bound by short time limits and in order to decide the course of action it needs to take to get disbursed, it is entitled to know all the basis for dishonour in good time.

The Subrule encapsulates the following three situations:

1. When the document checker (sometimes called the examiner) detected discrepancies in the documents but failed to give a notice of dishonour within the time-span indicated in Subrule 5.01, the bank on whose behalf the checker is acting bears the full responsibility of the documents that is it becomes obliged to honour the value of the presentation even though the documents contain discrepancies. This is because the bank is obliged to notify the presenter of the discrepancies within three days or seven banking days following the date of presentation as the case may be. The bank will be precluded from asserting any discrepancy contained in the documents if it does not notify the presenter of such discrepancy within the period of time allowed in Subrule 5.01.
2. When the document checker/examiner has negligently failed to detect and spot all discrepancies and therefore he/she issued an incomplete notice of dishonour omitting to include one or more of the discrepancies. Upon correcting the notified discrepancies by the beneficiary or waiving them by the applicant, and thereafter the bank has wrongfully honoured the presentation, it becomes liable to bear the consequences if the applicant refuses the documents because of the undetected discrepancies upon either receipt of the documents or receipt of the second late advice of bank. Once again, the bank will be precluded from asserting any discrepancy contained in the documents because it did not notify the presenter of such discrepancy in good time, that is, within the periods allowed in Subrule 5.01.
3. When the document checker has omitted a discrepancy from the notice of dishonour and later on it was decided that the discrepancies detected are trivial or without merit and therefore the presentation was honoured since the bank dishonour was treated as wrongful. The bank here bears the full responsibility for honouring the presentation and it would have been justified in not doing so had it not failed to include the undetected discrepancy(ies) in the first notice of dishonour once it was issued. The preclusion operates in this situation as well.

6.3.1 New discrepancies

The beneficiaries frequently take back the discrepant documents they present to the bank, cure the discrepancies and represent the documents again. Banks are accustomed to such practice and consider it as a value added service to their existing and potential customers. Nevertheless, it is necessary for both the documents checker and beneficiary to understand that the representation of documents in this case is considered a new presentation and is therefore treated as such. This means that the documents checker must examine the documents all over again to ensure that they do not contain any new discrepancy(ies) which gives rise to dishonour. For example, if the representation was made after the expiry date of the standby LC, then it is a discrepant one and will be dishonoured by the bank regardless of the fact that it was first presented within the validity of the credit. This also applies even if the examiner returned only the discrepant document to the beneficiary and kept the remaining documents of the presentation with him/her. Upon representing the discrepant document cured to the bank, the examiner will add it back to the set of documents he/she kept with her earlier and treat the whole set as a new presentation, such that if the banking day following receipt of the cured document is after the expiry date of the standby LC, then the whole presentation is a discrepant one.

6.3.2 Separate presentations

In circumstances where a documents checker fails to detect a discrepancy in a certain presentation, and upon checking a second presentation – under the same or a different standby LC – the checker spots the discrepancy that she previously omitted, the checker then may dishonour the presentation and the beneficiary or presenter can not demand payment on the basis that the previous presentation was honoured in spite of the discrepancy with regards to which payment is being halted. This result of Subrule (a) follows from the principle set forth in Subrule (b) and (c) of the ISP98 Rule 3.07 (Separateness of Each Presentation).

6.3.3 Overdrawn presentations

A demand requesting payment for more than the amount available under the standby LC is a discrepant one and the presentation containing it would not be honoured (Rule 3.08 (e) (Partial Drawing, Multiple Presentations; Amount of Drawings)). Even if a demand is overdrawn and the bank dishonours it for this reason but fails to give a timely notice of dishonour, Rule 5.03 operates only as for the amount available under the standby but not for the amount in excess of it.

Subrule 5.03 (b) provides that in standby LCs available by deferred payment or acceptance, the bank is also obliged to give a notice of dishonour in case of presentation of discrepant documents and must do so in a timely manner in accordance with the requirements of Subrules 5.01 and 5.02. If the bank fails to do so, it becomes obliged to honour the presentation in spite of the fact that the presentation was made long before such deferred date. In simple words, if a notice of dishonour is not given in a timely manner, the bank must pay the value of the presentation on the due date and can not escape the liability of doing so.

Moreover, the bank is obliged to give the beneficiary a notice of acceptance or acknowledgement that it has taken up the documents and incurred a deferred payment undertaking thereafter. If it fails to give such notice affirming compliance of presentment, it will remain obligated to pay. This literally means that if the bank remains silent regarding its decision to take up the documents, it can not reverse it if later on a discrepancy was found by another party to the LC such as the applicant for example; it will remain responsible for payment on the due date since this rule demands of the relative bank to give a notice of acceptance or confirmation that a deferred payment obligation has been accepted and payment shall be made on the maturity date.

6.3.4 The Scope of this Rule

This rule only applies to the issuers, confirmers and nominated persons acting upon their nomination in accordance with the provisions of Rule 2.04 (Nomination).

6.4 NOTICE OF EXPIRY

Rule 5.04 of the ISP98

The rule provides that a notice of expiry is not required. If a presentation was made after the expiry date of the standby, then the bank must dishonour the presentation without having to give any notice of dishonour, that is, the rule is exempted from the requirements of Rule 5.03 (Failure to Give Timely Notice of Dishonour) since the expiration automatically terminates the undertaking.

This simply means that in all circumstances, the document examiner must give, in a timely manner, a notice of dishonour stating all discrepancies in the presentation or else it becomes obliged to pay the full value of

the documents regardless of the discrepancies contained therein (Preclusion). So the bank is strictly responsible for checking the presentation and notifying the presenter, in good time, of the discrepancies. This is true in all cases except in the case where the presentation of documents is made after the expiry date of the standby. In this case the bank need not give any notice of dishonour and as such it can automatically dishonour the presentation. Similarly, if the document checker fails to note an expiry date discrepancy in a past presentation, it does not obligate the examiner to accept subsequent presentation containing the same discrepancy, this is because each presentation is a separate one (Separateness of Each Presentation – Rule 3.07).

6.5 SEEKING APPLICANT'S WAIVER WITHOUT REQUEST BY PRESENTER

Rule 5.05 of the ISP98

If upon checking the documents presented under a standby LC, the issuer finds discrepancies, then it may in its own discretion, approach the applicant with the request to waive the discrepancies and authorize honour thereafter. It is mandatory, however, to do so within the time allowed for giving a notice of dishonour but without extending. In other words, if the waiver was sought but declined by the applicant, then the issuer must give a notice of dishonour within the three business days following the business day of receipt of the presentation. In such a case, the issuer will not be precluded from claiming that the presentation is a discrepant one since it acted within the safe harbour period indicated in ISP98 Rule 5.01 (a) (i) Timely Notice of Dishonour.

Conversely, if the issuer sought a waiver of discrepancies from the applicant and could not obtain it, then naturally it must give a notice of dishonour to the presenter. If the issuer takes more than three business days but seven or less business days following the business day of receipt to issue the notice of dishonour, either of the following will be occur:

1. The issuer will be precluded from claiming that the documents are discrepant if it was decided that the period of four to seven business days is unreasonable.
2. The issuer would not be precluded from claiming that the documents are discrepant if the same period of four to seven business days was found to be unreasonable.

Finally, if the waiver of discrepancies was sought but the applicant refused granting it, and the issuer consequently issued a notice of dishonour but it did so after seven business days following the business day of receipt of the presentation, then it will bear the full value of the documents and hence become obliged to cover the applicant for the value of the documents in spite of the discrepancies. This is because giving a notice of discrepancies after seven business days following the date of receipt of the documents is forbidden by Rule 5.02 of the ISP98.

If the presenter/beneficiary elects to instruct the issuer not to request the applicant's waiver of discrepancies, then the issuer must abide with the applicant's instructions.

It remains to say here that even if the issuer obtains the applicant's waiver of discrepancies, it still can refuse to waive the discrepancies and therefore halt payment on the same grounds provided of course it abides with the relative rules of the ISP98.

To reiterate, this rule covers the situation where the issuer, acting on his own, seeks a waiver of discrepancies from the applicant. Nevertheless, in situations where the beneficiary/presenter requests the issuer to obtain the waiver of discrepancies from the applicant, the provisions of the next Rule 5.06 applies.

6.6 SEEKING APPLICANT'S WAIVER UPON PRESENTER'S REQUEST

Rule 5.06 of the ISP98

Beneficiaries who submit discrepant documents and thereafter receive the issuer's notice of dishonour, often request the issuer to directly approach the applicant for the purpose of obtaining the latter's waiver of discrepancies or otherwise its authorization to honour.

In cases where the beneficiary receives the notice of dishonour from a nominated bank or a confirming bank authorized to check the documents and thereafter issue said notice of dishonour, the beneficiary often asks such an authorized bank to forward the discrepant documents back to the issuer requesting it to approach the beneficiary directly for a waiver of discrepancies.

In such cases, Rule 5.06 (a) provides that the bank to whom such instructions are directed is not obliged to act upon them and may decline to forward the discrepant documents or seek the applicant's waiver. Nevertheless, banks normally act willingly upon the applicant's request to forward the

documents and seek the waiver of discrepancies or payment authority from the applicant.

Subrule 5.06 (b) describes the issuer's responsibility to recheck the set of documents received under the standby and previously checked by a nominated bank acting on its nomination or a confirming bank. The Subrule (c) (ii) states that regardless of whether or not the documents were previously checked by another authorized bank, and despite the fact that the set of documents is marked with phrases like 'Checked and Found Discrepant', 'Documents Sent for Collection', 'Documents Dispatched on Approval Basis' … etc., the issuer is obligated to treat the set of documents presented as a new presentation and re-examine them in accordance with the provisions of the ISP98 rules including Rules 5.01 (Timely Notice of Dishonour) and Rule 5.03 (Failure to Give Timely Notice of Dishonour). Hence, Subrule (c) (ii) provides that the issuer is not excused from its duty to examine the presentation if the documents were forwarded to the issuer together with a request to approach the applicant for waiver of discrepancies.

Nevertheless, the presenter may accept to waive the requirements of this rule, that is, it may accept that the issuer be relieved from checking the documents presented and thereafter the issuer will not bear any responsibility if it did not give a notice of dishonour in a timely manner and in accordance with the provisions of the ISP98.

Subrule (c) (i) provides that if the nominated bank or the confirming bank accepted to forward the documents to the issuer or if the issuer accepted the request of the presenter/beneficiary to seek the applicant's waiver, the presenter/beneficiary in this case will not be allowed to object to the discrepancies notified to it by the issuer. This is logical because by requesting the applicant's waiver, the beneficiary acknowledges that the documents are discrepant.

Subrule (c) (iii) states that regardless of whether or not the applicant waived the discrepancies, the applicant is not obligated to waive them; it may elect to waive the discrepancies and honour the presentation thereafter, or it may elect to reject the documents. The process of waiving discrepancies in a revolving standby LC, a standby available by partial drawing, an evergreen standby or any other automatically renewable standby, waiving the discrepancies could mean an extension of the issuer's risk exposure; hence, upon receipt of the applicant's acceptance to waive discrepancies, the issuer may decide not to waive such discrepancies to avoid certain risks.

Subrule (c) (iv) provides that the issuer is obliged to hold the documents at its counters until it receives a response from the applicant or receives a request from the presenter to return the documents. If no such response or request is received within ten business days of its notice of dishonour, then it may return the documents to the presenter.

The documents belong to the beneficiary and the issuer only holds them subject to the instructions of the former. To control the issuer's risk of holding the documents, this rule introduces the period of ten days of the issuer's notice of dishonour.

6.7 DISPOSITION OF DOCUMENTS

Rule 5.07 of the ISP98

After giving the notice of dishonour, the bank cannot place the dishonoured documents in its archives or fire proof Chubb safes unattended, since these documents are not its belongings; the documents are the property of the presenter. The issuer is obliged to either return the documents to the presenter, hold the documents pending further instructions from the presenter or dispose of the documents in any other way instructed by the presenter.

Failure by the bank to hold the documents at the disposal of the beneficiary may expose the bank to legal and operational and other risks which could be very costly.

The examiner must note that this rule does not apply in situations where the beneficiary instructs the issuer to obtain the applicant's waiver of discrepancies; in such situation the provisions of Subrule 5.06 (c) (iv) (Issuer Request for Applicant Waiver Upon Request by Presenter) apply.

This rule in essence is consistent with Article 16 of the UCP600 where the bank authorized to handle discrepant documents whether an Issuing Bank, a Nominated Bank acting on its nomination or a Confirming Bank must give a notice of dishonour to the beneficiary. Nevertheless, there is a major difference between Article 16 – UCP600 and Rule 5.07 of the ISP98 where in the former, Subrule (c) (iii) provides that the authorized bank returning the documents must state in the notice of dishonour one of the following facts:

1. That the documents are placed/held with the bank at the disposal of the beneficiary pending receipt of further instructions; or
2. that the issuing bank is holding the documents until it receives a waiver from the applicant and agrees to accept it, or receives further instructions from the presenter prior to agreeing to accept a waiver; or
3. that the bank is returning the documents; or
4. that the bank is acting in accordance with instructions previously received from the presenter.

The notice of dishonour given for a set of discrepant documents presented under a standby LC subject to the ISP98, need not state that the documents are being held under the disposal of the beneficiary or presenter. This is because the documents presented under a standby are normally of no significant commercial or legal value and therefore, it is unnecessary to include a sentence in the notice of dishonour notifying that the examiner is willing to act at the presenter's instruction. Accordingly failure to make such statement/sentence in the notice will not prevent the issuer from dishonouring the discrepant presentation.

6.8 COVER INSTRUCTION / TRANSMITTAL LETTER

Rule 5.08 of the ISP98

The covering schedule (sometimes called cover instructions or transmittal letter) of each presentation is considered an extraneous document and according to sub rule 4.02 of the ISP98, it may well be disregarded and must not have any impact on the examiner's work to check the documents. The covering schedule normally contains the name and address of the presenter, the types and numbers of the attached documents and instructions regarding the method of payment by which the beneficiary/presenter prefers to receive the money. It may also contain general information or remarks on the presentation such as any noted discrepancies in documents. Rule 5.08 allows the examiner to rely on the covering schedule if he/she chooses to do so provided that the schedule does not contain any instructions or directions that are prohibited by the provisions of the ISP98 or contradicts such provisions, the demand or the standby itself.

Subrule (b) also provides that the examiner may, if he/she elects to do so, rely on the representations made by the nominated bank, that is, the covering schedule of the nominated bank, provided of course that the terms of the covering schedule of the nominated bank do not contradict the terms and conditions of the standby, the demand or the provisions of ISP98.

Consistent with Rule 4.02, Subrule (c) states that notwithstanding receipt of any instructions contained in a covering schedule, the issuer or nominated person is entitled to deal directly with the presenter if it elects to do so unless of course the terms of the original standby prohibits such direct dealing.

The most obvious example is the case where the beneficiary's covering schedule requires the issuer to dispatch the discrepant presentation directly

to the beneficiary rather than sending it through the collecting bank. The issuer, if it elects to do so, may return the documents directly to the beneficiary without derogating from any of the ISP98 provisions. Further Rule 5.07 (Disposition of Documents) allows him to do so. If the documents were presented through a negotiating bank, it may disregard the covering schedule's instructions.

Subrule (d) states that even if the covering schedule of the beneficiary, the nominated bank or the confirming bank who has previously checked the documents, states that the documents are discrepant, the issuer must check the presentation on its own independently of other parties to the standby LCs. If the issuer finds the documents to be discrepant, it must of course give a notice of dishonour.

6.9 APPLICANT NOTICE OF OBJECTION

Rule 5.09 of the ISP98

After the issuer examines the presented documents, it will honour it if the documents were found conforming to the standby terms and conditions and the ISP98 provisions. Afterward, the issuer will deliver the documents to the applicant.

Upon receipt of documents, the applicant in turn will check them. If the applicant finds that the documents actually contain a discrepancy or more which the issuer did not spot – because of its negligence or omissions and as such the issuer wrongfully honoured a discrepant presentation – this rule allows the applicant to give a timely notice of objection to the documents, and recover payment thereafter.

Rule 5.09 acknowledges that the applicant is more capable than the issuer to check the documents and decide whether or not they are discrepant since the applicant fully understands the underlying transaction because it is a party to it.

Although Subrule (b) states that the applicant acts timely if it objects to the discrepancies by sending a notice to the issuer within an unreasonable time after receipt of documents, the rule does not indicate what is a reasonable or unreasonable time for the applicant. To avoid risks of delay in objecting to discrepancies, applicants normally refer to Rule 5.01 (Timely Notice of Dishonour) for guidance with regards to the interpretations of the timely notice, that is, a period longer than seven days after receipt of documents is definitely unreasonable.

Subrule (c) stresses that the applicant can not delay giving a notice of discrepancies to the issuer; a failure to give a timely notice of objection by prompt means prohibits the applicant from asserting any discrepancy against the issuer, but does not prevent the applicant from giving a notice of objection for any different presentation under the same or different standby.

CHAPTER 7

Transfer, Assignment and Transfer by Operation of Law

7.1 REQUESTS TO TRANSFER DRAWING RIGHTS

Rule 6.01 of the ISP98

The ISP98 allows the beneficiary to transfer its drawing rights to a third party. In general, the term 'transfer' is used to denote the beneficiary's request to allow a third person to draw on the standby letter of credit in place of the beneficiary himself. Similar to Article 38 in the USP600, a credit can not be transferred to a second beneficiary unless the credit itself expressly allows a transfer of the rights granted under it to a second beneficiary.

Under the ISP98, the term transfer is different from the term 'assignment of proceeds' as the latter does not confer a right to draw, it merely conveys the right to receive the proceeds already drawn by the original beneficiary himself.

This rule only explains the term 'transfer' whilst Rules 6.02–6.05 cover the whole aspects of the transfer process.

7.2 TRANSFERABILITY OF DRAWING RIGHTS

Rule 6.02 of the ISP98

Because of the unique and distinctive nature of both standby and commercial LC, the provisions of Article 38 (b) of the UCP600 are distinctively different

from the provisions of Rule 6.02 noting that both articles are on transferable credits. One similar feature however, is the requirement to expressly indicate in the text of the credit itself that it is 'transferable'; a credit simply can not be transferred unless it is clearly marked as 'transferable'. Subrule 6.02 so states.

The logic behind this provision is to mitigate the operational risk to which the bank authorized to honour the documents and the applicant himself may be subjected if the transfer process was allowed merely on the basis of presenting compliant documents. It is necessary that the standby LC contains the word/term 'transferable'.

Subrule 6.02 (b) (i) states that if the credit is transferable, it may be transferred in its entirety more than once, that is the second beneficiary of the standby LC can transfer it in whole to a third beneficiary and the third beneficiary in turn can transfer it to a fourth beneficiary and so on. Partial transfers are not allowed. Conversely, Article 38 (d) of the UCP600 allows the transfer of the credit only once to one or more than one second beneficiary, that is, the credit may be transferred in whole or in part.

Rule 6.02 (b) (ii) provides that the transferable standby credit must only be transferred in its entirety and can not be transferred in parts (Partial Transfers Prohibited). Once again, this rule differs from Article 38 (d) that permits banks to make partial transfers to one second beneficiary or more, provided of course that partial drawings or shipments are allowed, that is, if partial drawings/shipments are not allowed, the credit must not be transferred to more than one second beneficiary; the bank that receives such instructions needs to request an amendment from the issuer so that the terms may be corrected to become operative. The difference between the provisions of the two articles stems from the different nature of the commercial documentary credit where the goods imported may be provided by many suppliers through a middle man, meanwhile a standby credit seldom needs partial transfers; at least past experience has proved so.

It is useful to note that if the applicant is a valuable client of the issuer and it wishes to issue a transferable standby credit that provides for partial transfers, then the bank may include a term in the standby LC itself indicating that it altered the requirements of Subrule 6.02 (ii) and as such the standby allows partial transfers. This of course would place the issuer and any other nominated bank under a higher operational risk since it has to deal with more presentations.

Subrule 6.02 (b) (iii) states that the issuer, a nominated bank acting on its nomination or the confirming bank if any, are under no obligation to transfer the credit except to the extent and in the manner expressly consented to by that bank.

Transferring a credit means transferring the right to present documents to the bank (draw on the credit) from the first beneficiary to a new second beneficiary.

Sub-article 6.02 (b) (iii) states that the standby LC need not indicate a person specifically nominated to effect the transfer. However, the provision dictates that the persons authorized to transfer the standby are the issuer, the nominated person or the confirmer if any.

7.3 CONDITIONS TO TRANSFER

Rule 6.03 of the ISP98

Upon requesting a transfer of a transferable credit, the transferring bank (issuer or another authorized nominated person), may effect the transfer after ensuring that a specific operational protective measures are taken. These protective measures are identified in this rule.

The rule provides that the issuer or a nominated person authorized to act under the standby is not obliged to transfer the standby LC simply because of its nomination or receipt of the original credit. It has the full right to check the authenticity of the standby LC or otherwise satisfy itself as to the existence of the original standby in order to detect and prevent fraud where possible, in addition to mitigating other operational risks.

Some few examples of the fraudulent acts that a bank seeks to detect and prevent are:

1. Transferring the same credit several times to different persons.
2. Transfer of an illusionary transferable standby that does not exist.
3. Transfer of a fully or partially utilized standby with no available balance.

Subrule 6.03 (b) states these measures are:

i. A request in a form acceptable to the issuer or nominated person including the effective date of the transfer and the name and address of the transferee. This form would also include some legal warranties and indemnities to protect the bank from attendant risks upon transfer. The practitioners need not worry about the content of these pre-printed phrases which are prepared by the legal department of the bank, they must, however, be careful in filling out the details of the transfer form.

ii. Checking the original standby would eliminate any doubt regarding whether or not the standby was previously drawn upon or transferred. Its genuineness would also be detected.

iii. Verification of the signature of the signatory authorized to sign on behalf of the beneficiary. The issuer would then evade any liability to which it may be exposed to if it transferred the standby credit acting on the orders received from someone who is not authorized by the beneficiary to give such order/transfer request.

iv. Payment of the transfer fees: The subrule recognizes the transferring bank's right to place charges on the transfer transaction.

v. Other reasonable requests. The subrule allows the transferring bank to take whatever protective measures deemed by it reasonable to effect the transfer.

The transferring bank would normally abide with the requirements of this rule although it may not do so. This is to protect its rights to receive due reimbursements.

7.4 EFFECT OF TRANSFER ON REQUIRED DOCUMENTS

Rule 6.04 of the ISP98

Article 38 (h) of the UCP600 grants the first beneficiary the rights to substitute its invoice and draft, if any, for those of a second beneficiary for an allowed amount, and upon such substitution the first beneficiary can draw on the credit for the difference, between its own invoice and the invoice of the second beneficiary. As such, the commercial transferable credit is different in nature from the standby credits; the latter requires drawings to be made by the transferee beneficiary but permits the original beneficiary to replace its name in any required document without amending the standby credit.

Subrule (a) is based on the rationale that the drawing rights in transferable standby credits are totally transferred to the transferee (second) beneficiary upon effecting the transfer, hence, the first beneficiary can not draw under the standby any more. For this reason Subrule (a) requires that the draft and/or demand must be signed by the transferee beneficiary regardless of the fact that the standby LC requires the signature of the original beneficiary on a demand or draft.

The words 'transferee beneficiary' are used in the ISP98 instead of the term 'second beneficiary'. This is to cover the case of multiple transfers where a third or fourth beneficiary may be involved.

Subrule (b) provides that the name of the transferee beneficiary may be substituted by that of the original beneficiary in any document other than the demand or draft if the standby so stipulates.

Since this rule is optional, the document can bear the name of either the first beneficiary or the subsequent beneficiaries (second, third, forth … etc., and as appropriate).

7.5 REIMBURSEMENT FOR PAYMENT BASED ON A TRANSFER

Read now Rule 6.05 of the ISP98

First, this rule stresses the transferring bank's right to reimbursement upon honouring the value of a compliant presentation made under the standby by the transferee beneficiary.

The transferring bank would only pay the beneficiary if (a) it is acting on the strength of the original standby, that is, a valid authority to act, (b) obtained a soundly signed request containing all the necessary details such as dates, transferee's name, address … etc., and (c) scrutinize the original standby pursuant to Rules 6.03 (a), (b) (i), and (b) (ii) respectively. The rule indicates that the transferring bank which pays under the transfer is entitled to reimbursement as it had paid the beneficiary.

In essence, this rule places the risk of transferring the standby credit at the first beneficiary's request to the applicant. Nonetheless, the risk of errors made by the transferring bank can not be shifted, for example transferring a nonexistent standby or a standby of terms inconsistent or different from the original ones … etc.

7.6 ASSIGNMENT OF PROCEEDS

Rule 6.06 of the ISP98

This rule indicates the distinction between the transfer of a standby credit and an assignment of proceeds. The former entails a full transfer of rights to draw on the credit, that is, the transferee beneficiary replaces the first

beneficiary. Conversely, the assignee of the credit proceeds is not a party to the credit itself and as such can not draw on the credit.

Another major difference between the assignment of proceeds and transferring a credit, is that the former permits the beneficiary to assign only part of the proceeds whilst the latter prohibits partial transfers (Rule 6.02 (b) (ii)).

Upon giving the issuer or any other bank authorized to act under the credit instructions assigning proceeds to a third party, the concerned bank acknowledges that the beneficiary has made an irrevocable assignment instruction allowing the bank to pay to the designated assignee in full or in part the value available under the credit.

It also serves as an introduction to the next ISP98 Rules pertained to assigning all or part of a credit proceeds.

The local law always supersedes the ISP provisions. The Rules on assignment of proceeds apply except where applicable law otherwise requires. This is an emphasis of the principles previously established in Rule 1.02 Relationship to Law and other rules.

The transferee beneficiary may also issue an assignment of proceeds and request that the relative bank acknowledges such an assignment. This is because the term beneficiary used in the Rule 1.11 (c) (ii) includes 'transferee beneficiary'.

7.7 REQUEST FOR ACKNOWLEDGEMENT

Rule 6.07 of the ISP98

Subrule (a) states that the issuing bank, a nominated bank or any other person authorized to act under the standby, is not obliged to execute any instructions from the beneficiary requesting to assign the proceeds due from a standby LC; it may elect to accept the assignment of proceeds or it may choose to reject it. If, however, it chooses to accept it, then it must acknowledge the beneficiary of its acceptance. The acknowledgement may be made by any form of communication: a letter, email, telex or SWIFT message … etc.

Subrule (b) (i) states that the rights of the assignee arising from an acknowledgement of proceeds are subject to alteration or cancellation, unless otherwise stated in the terms of the assignment or acknowledgement. Hence, the beneficiary's instructions for the issuer or a nominated bank authorized to act under the standby may either be revocable or irrevocable. Nevertheless, banks seldom acknowledge a revocable assignment of proceeds

and almost always require the beneficiary to certify that the assignment of proceeds is irrevocable. Once the assignment is acknowledged, the issuing bank or nominated bank becomes obliged to honour it and as such the assignee would be paid according to the terms of the assignment or acknowledgment.

An acknowledged assignment of proceeds confers no rights to the assignee under the standby except the right to assigned proceeds. Hence, the assignee has no rights to draw on the standby or act under it.

Subrule (b) (i) indicate that the assignee will only be paid the money of the acknowledged assignment of proceeds, if the issuer or nominated person, who already acknowledged the assignment and is supposed to pay the proceeds, determines that:

1. there are net proceeds available to be paid to the beneficiary. Paying these proceeds to the beneficiary depends on a host of factors such as the terms of the assignment and the priorities.
2. the rights of a nominated bank acting upon its nomination and the transferee beneficiaries whose rights precede those of the assignee. The question of which rights ought to be met first is a legal one and ought to be determined by the bank's lawyer.
3. the rights of other acknowledged assignee are properly considered in accordance with the terms and conditions of the assignment of proceeds; the acknowledgement itself frequently require covering certain amounts, fees, charges before paying the proceeds of the assignment to the assignee.
4. there are other rights and obligations that must be met by local laws.

7.8 CONDITIONS TO ACKNOWLEDGEMENT OF ASSIGNMENT OF PROCEEDS

Rule 6.08 of the ISP98

An issuer or a nominated person that elects to acknowledge an assignment of proceeds would undertake several measures to mitigate the operational risk of the transaction. In this regard, the most common measures taken by banks are:

A. The submission of the original standby for examination: Inspecting the original standby reveals the validity of its terms, available balance, previous notices, special instructions, cancellations, and any other previous actions taken in relation to the standby.

B. Authentication of the signatory officially signing on behalf of the beneficiary; this is especially important because payment will be made to a third person (assignee) who may well be unknown to the bank.

C. Additionally, Subrule (c) indicates that the bank may also verify the limits of authority of the signatory in addition to his/her signature.

D. Subrule (d) states that the request for an acknowledgement of assignment of proceeds is normally a pre-printed form containing the bank's warranties and waivers and indemnities. The subrule also lists the transaction details and other provisions.

E. Subrule (e) recognizes the acknowledger's right to charge appropriate fees for the transaction.

F. Subrule (f) allows the acknowledger to add to the list of Subrule (d) above any additional provisions it deems appropriate.

7.9 CONFLICTING CLAIMS TO PROCEEDS

Rule 6.09 of the ISP98

Payment of a standby proceeds in case of conflicting claims is necessarily guaranteed to the assignee; there may be other claims of first priority that must be honoured, either by law or by the provisions of the ISP98 Rule 6.07 (b) (ii), prior to executing the assignment in favour of the beneficiary. For example, the rights of the second beneficiaries, nominated banks, other legitimate assignees … etc.

This rule is of high significance because it grants the issuer or the nominated bank the right to halt payment under an assignment of proceeds until such time the allocation of rights between the different parties is identified.

7.10 REIMBURSEMENT FOR PAYMENT BASED ON AN ASSIGNMENT

Read Now Rule 6.10 of the ISP98

This rule is a mere reiteration of the right of the issuer or the nominated bank to reimbursement upon paying the proceeds of the assignment to the

assignee. Payment to an assignee is treated the same as payment to a beneficiary with regards to rights of reimbursement.

This rule indicates that payment by an authorized bank under an assignment of proceeds pursuant to Rule 6.08 (a) and (b) obliges the bank to check and authenticate the original standby or mark it and verify the signature of the beneficiary's signatory. Only then the issuer or nominated bank becomes entitled to reimbursement as if it had made payment to the beneficiary, and the risk of duplication in payment will be borne by the applicant.

The rule clarifies that when the beneficiary is a bank, it is adequate to authenticate the request for acknowledgement received from it by the normal means without having to follow the procedures for non banks customers/parties mentioned earlier, that is, authenticate the original standby credit or make a notation on it … etc.

7.11 TRANSFER BY OPERATION OF LAW

Rule 6.11 of the ISP98

On several instances, law courts order the issuers or nominated banks to pay the proceeds of the standby LC to a person other than the beneficiary of the standby or otherwise allow such person to become the successor of the beneficiary and as such act for it legitimately under the standby. This may happen on several occasions, for example, if the beneficiary dies, his heirs may become eligible for the proceeds and in such a case the court of law would order the bank concerned to effect payment for them. There are many other occasions under which a person may become a transferee by law. These occasions are listed in the text of the rule.

A transaction involving an operation of law, is usually dealt with by the legal department of the bank. Hence, the LCs' practitioners need not search or study these cases due to its complex legal nature.

The following subrules on a transfer of a credit by operation of law indicate the procedures that need to be adopted in order to complete the transfer whilst preserving the rights of the issuer to reimbursement.

7.12 ADDITIONAL DOCUMENT FOR DRAWING IN SUCCESSOR'S NAME

Rule 6.12 of the ISP98

If the court of law (or a public official) appointed a successor as a survivor of merger, consolidation, or similar action of corporation, limited liability

company or other similar organization, and such appointed successor presented the official letter of appointment in addition to the documents stipulated by the standby, in such case the claimed successor will be treated as if it were an authorized transferee of a beneficiary's drawing rights in their entirety, provided:

a. The official document indicates that the claimed successor is authorized or appointed to act on behalf of the credit beneficiary or its estate due to insolvency;
b. Or that the claimed successor is authorized or appointed to act on behalf of the named beneficiary because of death or incapacity;
c. Or that the name of the named beneficiary has been changed to that of the claimed successor.

In simpler words, the rule clarifies that the document evidencing succession must be issued (or appear to be issued) by a public official, judicial officer or any other authorized tribunal. Such documents of course must not be treated as extraneous documents (Rule 4.02) since they are officially issued by the government or the court.

The rule did not indicate that the document needs to contain a specific text, so a general document conveying clearly its purpose would be adequate. Once again, it is not the responsibility of the trade finance practitioners to check the content of such documents; they must be handed over to the legal department to check.

Upon drawing on the standby LC, the successor must present the documents within the valid periods stipulated by the LC itself; otherwise the documents will be considered as discrepant.

7.13 SUSPENSION OF OBLIGATIONS UPON PRESENTATION BY SUCCESSOR

Rule 6.13 of the ISP98

Upon receipt of a complying presentation from a claimed successor instead of the beneficiary, the issuer or a nominated bank would naturally want to consult the bank's legal department for clarifications and will want to obtain the official or judicial order of appointment for the successor which evidence that the successor is the replacement of the original beneficiary. These points are what Subrules (a) (i) and (ii) indicate. This is to verify the authenticity of the successor and the transaction.

Subrule (a) (iii) allows the issuer or nominated person to obtain whatever statements, covenants and indemnities it requires to protect and assure itself of the claimed successor and its status.

Subrule (a) (iv) permits the issuer or nominated bank to request payment of reasonable charges the bank places to recover costs arising from carrying out the actions stated in (i), (ii) and (iii) above. This because authentication of the successor's transaction and verifying the successor's identity is a lengthy process that requires addressing many legal issues and operational concerns by specialized people and this in turn is a costly process.

Subrule (v) grants the issuer or nominated bank the right to request any additional document or take whatever necessary actions to protect itself and ensure the sound completion of the transaction. This includes anything that may be required under Rule 6.03 (Conditions to Transfer), or an acknowledgement of an assignment of proceeds under Rule 6.08 (Conditions to Acknowledgement of Assignment of Proceeds).

One very important point to remember here is that even if the requested documents were presented after the expiry date, the presentation does not constitute a discrepancy, that is, the bank is obliged to accept it because in essence, such documents are not part of the stipulations of the original standby.

Subrule (b) provides that if the issuer or nominated person requires additional documents, then its obligation to honour or give notice of dishonour is suspended. This is because it was not possible to examine the documents until such time the bank was able to verify the identity of the successor and authenticity of the transaction. The suspension does not allow the successor to amend, represent or cure any of the documents presented under the standby, that is, the suspension does not extend the successor beneficiary's deadline to present documents originally required by the standby credit but only additional documents pertaining to the successor's transaction and required under this rule by the issuing or nominated bank so, for example, if the standby expired during the suspension, the beneficiary can not cure any discrepancies in the documents which he would otherwise have done had he presented the full set of documents within the validity of the standby.

7.14 REIMBURSEMENT FOR PAYMENT BASED ON A TRANSFER BY OPERATION OF LAW

Rule 6.14 of the ISP98

The issuer or nominated person paying to the successor by operation of law, pursuant to Rule 6.12 is entitled to reimbursement as if it had made payment to the beneficiary. This in essence is a protection to the rights of the issuer

or nominated person who makes payment in such circumstances, that is, the bank that pays pursuant to Rule 6.12 does not really comply with the terms and conditions of the standby since it does not to the beneficiary of the standby and as such its rights to reimbursement may be compromised; to protect the paying bank, the rule provides that it must be reimbursed as if it has paid the beneficiary.

It is absolutely necessary for the issuer or a nominated person – who pays for a successor in an operation of law – to do so on the strength of an additional document that appears to be issued by the court or an authorized governmental body and complies with the requirements of Rule 6.12. Furthermore, Rule 6.13 allows the bank to request whatever new documents it needs to verify or conclude the transaction successfully; the bank may elect not to request any other documents under this rule and if it did so, it will continue to be eligible for reimbursement.

CHAPTER 8

Cancellation

8.1 CANCELLATION OR TERMINATION OF AN IRREVOCABLE STANDBY

Rule 7.01 of the ISP98

Rule 7.01 of the ISP98 is similar to Article 10 A of the UCP600 which provides that a credit can neither be amended nor cancelled without the prior agreement of the issuing bank, the confirming bank, if any, and the beneficiary.

This rule reiterates the irrevocable nature of the standby letter of credit. It provides that the standby may not be revoked without the prior consent of the beneficiary. Consent may be evidenced either explicitly by returning the original standby credit with a covering letter indicating its cancellation, or alternatively it could be evidenced implicitly by action such as returning the original standby in a way indicating its cancellation.

The consent of the *beneficiary* includes, the transferee and a successor by operation of law.

The cancellation of a standby would normally be requested by the applicant when the underlying transaction has been completed and the obligation of the standby is no longer needed, or the security provided by the standby has been replaced by another instrument. Of course the applicant would always want to cancel the standby in order to free its credit lines and mitigate its operational risks.

Put simply, the standby LC can not be cancelled without the consent of the beneficiary, any transferee and the issuer. In addition, the confirming bank and any nominated bank acting upon its nomination must consent to the cancellation prior to cancelling the standby credit. As such the issuer

may elect not to cancel the credit upon request and even if it approved to cancel the credit, it will remain entitled to reimbursement.

This rule provides that once the beneficiary advises the issuer that it consents to cancelling the standby, such consent is irrevocable and the beneficiary therefore can not withdraw it afterwards, that is, once the issuer receives the beneficiary's consent to cancel the standby, it can not revoke the consent. However, if the issuer decides not to cancel the standby, it remains valid and may as such the beneficiary may draw on it until it expires.

The term cancelled includes all words bearing a similar meaning, hence cancellation, termination, terminate, cancel, abolition, nullification, rescission … etc.

8.2 ISSUER'S DISCRETION REGARDING A DECISION TO CANCEL

Rule 7.02 of the ISP98

The cancellation of a standby entails a series of actions that must be taken by the issuer as part of its operational control and organization endeavours. Today many banks are fully automated and updating their books, that is, recording the outstanding balances for reporting and risk management purposes, is done automatically by the banks' computer solutions. Nevertheless, for banks that are semi automated, updating the correspondent banks' limits and recording outstanding liabilities for monitoring the banks' capital adequacy and financial control purposes is done manually or semi manually. Further, any lien on deposits previously taken upon issuance as a security (margin deposits) will need to be released. Furthermore, if there are any obligations to a second beneficiary, a nominated person or a confirming bank, the cancellation process would entail payment of additional costs and risks and the bank may need to take measures to deal with the situation arising.

This rule indicates that the issuer is not obligated to accept a request for cancellation, but if it elects to do so, it may request in any form and substance it deems appropriate, the list of documents and details as specified in a-h of Rule 7.02.

The stated conditions on which the issuer may impose and subject its consent on cancellation to, are merely listed for educational purposes and are not mandatory but optional, that is, the issuer may choose to impose all, some or none of them.

Amongst these optional conditions are verifying the beneficiary's signature. It may also request the submission of the original standby for cancellation and

ascertaining whether any existing obligations (previous drawings, transfers, negotiations etc.) are noted.

It is very important that the issuer gives a notice of cancellation to a nominated or a confirming bank in order to avoid liability for the nominated or confirming bank who may have undertaken obligations on the strength of the standby credit. It remains to say here that retention of the original standby credit does not make it upon cancellation a valid one and hence all rights granted by it are also nullified.

The other requirements that may be undertaken or imposed by the issuer is obtaining the legal department's opinion to confirm that the cancellation is authorized. It may also require the beneficiary to sign a pre-printed form indemnifying the issuer from any liabilities and containing standard legal clauses. Such forms are legal in nature and need not be fully studied by LCs practitioners.

CHAPTER 9

Reimbursement Obligation

9.1 RIGHT TO REIMBURSEMENT

Rule 8.01 of the ISP98

Subrule (a) stresses the right of the issuer, a nominated person that has paid pursuant to its nomination or a confirmer for reimbursement upon honouring a compliant presentation. The subrule obliges the applicant to reimburse the issuer which issued the standby credit upon the former's request; and it also obliges the issuer to reimburse a nominated bank that has honoured or otherwise given value whilst acting upon its nomination. Hence, the obligations of both the issuer and the applicant to reimburse for payments made against complying presentations is well established in this rule.

Often banks would subject reimbursements under standby LC to the URR525 (Uniform Rules for Bank-to-Bank Reimbursements) which are a set of comprehensive rules published by the ICC – Paris to regulate the reimbursements between banks.

There could be more than one person responsible for reimbursement under this rule. This is because the term applicant includes a person who arranges for the issuance of the standby credit for the account of another and also the issuer when it issues the credit on its own behalf in addition to the person who authorizes the issuance of the standby in its own name for its own account and as such its name appears in the credit.

Subrule (b) provides that the applicant must indemnify the issuing bank against all liabilities and obligations that may arise in relation to:

a. Law and practice in countries different than those stipulated in the standby.

Example: An Italian importer agreed to import beef from a Romanian merchant. In addition to other details of the transaction, the merchants agreed that the Romanian exporter will open a standby letter of credit in favour of the Italian importer for the value of the transaction, allowing the latter to draw on the standby in case the merchandize was not shipped as per agreement or received within the time frame agreed upon. The goods had to be transshipped via Hungary and whilst the ship was unloading the good at the Hungarian port, the Hungarian government passed a legislation prohibiting transporting any food stuffs through its lands.

Because the Italian importer did not receive the shipment in time, he drew on the standby letter of credit for the full value. The nominated bank then forwarded the presentation to the issuing bank requesting reimbursement for the value paid, and the issuer in turn procured reimbursement in a timely manner. Upon delivering the claim for the applicant, the applicant objected on the basis that it has shipped the goods in time and as per the terms and conditions of the agreement with the Italian merchant. The reason for the delay was the new law of the Hungarian government. Since the Rule 8.01 (b) obliges the applicant to indemnify the issuer against all loses arising out of the imposition of law or practice other than that chosen in the standby, then the applicant here becomes obliged to reimburse the issuer for the value paid to the beneficiary.

b. Fraud, forgery or illegal action of the others.

Example: A standby that was honoured by the issuer against forged documents that appeared to be authentic and compliant. In this case the applicant must reimburse the issuer even though the presentation is illegal. This is because the rule obliges the applicant to indemnify the issuer.

c. The issuer's performance of the obligations of a confirmer that wrongfully dishonours a confirmation. This is where the issuer is liable to cover for the acts of a confirming bank that fails to honour a complying presentation (ISP98 Rule 2.01) and is entitled to reimbursement by the applicant as per this rule.

This rule also obliges the applicant to cover the issuer for all expenses and fees (including legal fees) incurred in addition to the reimbursement amount.

Subrule (c) is more legal in nature and need not be understood in full by trade finance practitioners since it has no direct bearing on their operations. It is adequate to know that Rule 8 as a whole supplements any other set of rules or agreements, course of dealings, customs or usage providing for reimbursements. This is because the ISP98 is not comprehensive in addressing

the reimbursement obligations between the parties to the documentary credit transaction in general and the applicant and issuer in particular.

9.2 CHARGES FOR FEES AND COSTS

Rule 8.02 of the ISP98

This rule obliges the applicant to pay the charges of the issuer for issuing the standby LC including any charges the issuer paid to a person under the standby to advise, confirm, honour, negotiate, transfer or to issue a separate undertaking.

Even if the charges were for the account of the beneficiary, the applicant is obliged to reimburse the issuer for any charges incurred by the latter because the beneficiary for some reason did not pay these charges. So ultimately, unpaid charges are for the account of the applicant.

Subrule (b) states that the issuer is obligated to pay the charges due to an advising bank, a nominated bank or a confirming bank in the following two circumstances:

a. If the standby stipulates that all charges, or any part thereof, are for the account of the issuer.

b. If the charges are for the account of the beneficiary/presenter but it is not possible to recover them because the beneficiary did not draw on the standby and as such refuses to pay any charges, such charges automatically become the responsibility of the issuer, and an advising bank, a confirming bank or a nominated bank is entitled to claim said charges directly from the issuer.

Counter Standby LCs: In cases where the beneficiary of the standby is requested to issue a counter standby (Rule 4.21 of the ISP98 – Request to Issue a Separate Undertaking) on the strength of the original credit, the applicant is also obliged to reimburse the issuer for any charges incurred in relation to the issuance of the counter standby.

9.3 REFUND OF REIMBURSEMENT

Rule 8.03 of the ISP98

Upon presenting the documents to a nominated person who is acting upon its nomination, that person will examine the documents to determine

whether or not they contain any discrepancies. If the documents were mistakenly found compliant, that is, the documents contained a discrepancy which the nominated bank did not spot, the nominated bank will then honour its value by either paying the beneficiary or presenter at sight or undertake to pay at a deferred date, accept a draft or negotiate the value of documents. The nominated person will then claim reimbursement from the issuer in case of sight payment and at the same time will forward the documents to the issuer normally by a courier service. The nominated person almost always receives reimbursement from the issuer before the forwarded documents are received by the issuer.

Upon receipt of the documents by the issuer, they will be examined and upon spotting the discrepancy that was overlooked by the nominated person, it will ask the latter to return the reimbursement amount that was already paid to it by either crediting its account with the issuer or crediting its account with a third reimbursing bank. In such circumstances, the nominated bank is obliged to return the reimbursement funds immediately upon receipt of the issuer's request in addition to any accrued interest.

It is important to note here that regardless of whether a refund of reimbursement was made, the nominated bank does not assert that the issuer's dishonour is accurate and binding; the nominated bank has the right to protest if it questions the issuer's dishonour and as such it can insist on its claim for reimbursement.

9.4 BANK-TO-BANK REIMBURSEMENT

Rule 8.04 of the ISP98

In commercial LCs, the credit becomes subject to URR (Uniform Rules for Bank-to-Bank Reimbursements – ICC) only when the credit itself stipulates so. In standby LCs, a standby subject to ISP98 becomes automatically subject to the URR.

The Uniform Rules for Bank-to-Bank Reimbursement is an independent set of rules inaugurated by the ICC in Paris for the purpose of regulating the reimbursement process between banks.

CHAPTER 10

Timing

10.1 DURATION OF THE STANDBY

Rule 9.01 of the ISP98

This rule provides that a standby must contain an expiry date or alternatively the standby must allow the issuer to terminate the standby upon reasonable prior notice of payment.

Hence, neither the issuer can issue a standby without an expiry date or a term allowing the issuer to terminate the standby within a reasonable period prior to notice of payment, nor the advising bank should advise a credit that does not bear such an expiry date or term. This is because the international standard banking practice does not allow issuing perpetual credits.

An important point to remember is that the Subrule (b) allows the beneficiary a reasonable time to draw on the standby. The issuer can not, therefore, terminate the standby after the beneficiary's claim/presentation has been received by either the issuer, the confirmer or a nominated person acting on its nomination. Further, when the standby indicates the time period within which prior notice must be given, the beneficiary and applicant are deemed to have received a reasonable notice.

In revolving standby LCs or evergreen standby LCs, the credit is renewed automatically on its expiry date or reinstated upon utilizing the available balance under it. These credits often contain additional clauses permitting the issuer not to renew the standby by giving notice to that effect. Naturally, the issuer is obliged to reimburse a nominated person, acting upon its nomination, have honoured under the standby credit a compliant presentation prior to receipt of notice of non-renewal.

Subrule (b) clearly states that the termination of the standby can only happen upon reasonable prior notice or payment. It does not allow for 'expiry events' by subjecting the termination to the presentation of a document the submission of which is not entirely within the control of the issuer.

10.2 EFFECT OF EXPIRATION ON NOMINATED PERSON

Rule 9.02 of the ISP98

This merely clarifies that a nominated bank acting upon its nomination, is entitled to reimbursement even after the expiry of the credit in case it honoured a presentation under a standby made within the validity of the credit and was compliant.

10.3 CALCULATION OF TIME

Rule 9.03 of the ISP98

Subrule (a) provides that calculation of time begins on the business following the day of receipt of the instruction to be acted upon or following the occurrence of the event that triggers the action to be taken by the bank.

A business day is different from a calendar day; a business day is the day on which the bank concerned with the specific action to be taken is normally open for business whilst a calendar day is any day.

Subrule (b) provides that an extension period begins on the calendar day following the expiry date stipulated by the standby.

10.4 TIME OF DAY OF EXPIRATION

Rule 9.04 of the ISP98

The close of business at the expiry date is the time of expiration. Nevertheless, if the credit stipulates an earlier time during the expiry date, say 11.00 am, for example, then the credit expires at this time. This rule

aims at clarifying that it is not the 24 hours cycle that determines the valid time for presenting documents.

10.5 RETENTION OF STANDBY

Rule 9.05 of the ISP98

This rule provides that the retention of the original standby is literally worthless after the standby was honoured or cancelled or expired, that is the retention of the original standby does not affect the obligation of the issuer, confirmer or an authorized nominated person after the right to demand payment is fulfilled by the person authorized to fulfil it.

CHAPTER 11

Syndication/Participation

11.1 AN OVERVIEW

The process of Syndication and Participation is an extremely complex one and it is almost always being handled by various banks differently depending on the country, bank's policies, risk issues and legal environment.

A syndicate is an association of two or more banks, established to grant a loan, issue an LC or extend any other type of banking facilities. Awarding banks share in all profits or losses, in proportion to their contribution to the resources of the syndicate. In essence, it is a joint venture, a partnership.

Syndication is handled by senior trade finance staff who come across it usually in one of the following instances:

1. Issuing a syndicated documentary credit on behalf of a corporate client of the bank and handling the consequential arrangements arising therefrom such as checking documents and settlements.
2. Handling the request made by the bank that issued the syndicated documentary to confirm such credit.

Syndicated LCs are either issued as (1) a unified transaction completely handled by one bank who leads the issue, checks the documents and pays on behalf of the other participants of the syndicate. The lead bank also acts as the public voice of the syndicate or as (2) a set of partial transactions where each issues, checks and pays thereafter its share of the syndication.

11.2 ISSUING SYNDICATED LCS AND MANAGING OPERATIONS

Aiming to mitigate the credit risks of a favourable but relatively large documentary credit transaction, a group of banks arrange to share the issuance of

the LC where each undertakes upon itself a proportion of the transaction's total risk. Prior to issuance, the participating banks sign a *Syndicate Letter of Credit Agreement* which encapsulates the terms and conditions of the transaction. The participating banks appoint a lead bank to manage most aspects of the issuance process. The lead bank could be the participant with the highest share of the transaction or simply the one with intensive technical knowledge to manage such transactions.

The *Syndicate Agreement*, usually drawn by the lead bank, contains the following aspects of the transaction:

1. The goods, services or accountability/default
2. The value
3. Validity
4. Stipulated documents
5. Examining documents and handling the presentation
6. The text of the LC
7. Amendments and how to be handled
8. Handling discrepant documents
9. Fees and charges
10. Claims
11. Securities received for the transaction

11.2.1 Syndication and participation in the ISP98

Rule 10.01 of the ISP98

Often banks avoid to issue a standby LC for large amounts in order to mitigate the risks of doing so. Frequently, several banks group themselves together to issue credits with relatively large amounts, that is, they syndicate the issuance of the standby. In such cases, if the standby does not stipulate to whom the presentation must be made, then the presentation may be made to any issuer and as such it is binding on all. This implicitly means that all issuers are jointly and severally liable for the entire amount of the standby credit if it did not state the percentage of the standby amount for which each one of them is liable.

Normally the syndicated standbys are issued based on lengthy agreements with full details including where and to whom a presentation need to be made in order to become effective.

The difference between Syndication and Participation is that in Participation only one issuer is responsible for honouring the conforming presentation of the beneficiary whilst in Syndication all issuers are liable to honour the presentation each in according to its proportion of the credit amount.

11.2.2 Participation

Rule 10.2 of the ISP98

Participation is distinguished from Syndication in that the issuer on its own is liable before the beneficiary. In Syndication the situation is different in that there are many participants in the issuing of the syndicate standby LC and all of whom are liable to the beneficiary each according to its proportion of the credit amount. Participation brings comfort to the beneficiary since it only has to look to the issuer for payment regardless of the other participants of the standby LC.

Subrule (a) allows the issuer to sell participations in its rights to reimbursement against the applicant and to disclose whatever necessary information, about the applicant and the application, to the parties invited to participate. This includes the enclosure of details on the financial and credit standing of the applicant.

In many countries, the law and banks' secrecy rules prohibit the enclosure of financial details of customers by banks. This rule provides an advance notification that financial details of the applicant may be disclosed in confidence and as such the confidentiality of the applicant will be protected. The point to be kept in mind is that the law supersedes the provisions of the ISP98 and as such it is important to seek legal advice prior to disclosing any confidential financial information on the applicant.

Subrule provides that regardless of the existence of participants in the issuance of the standby LC, the obligations of the issuer towards the beneficiary will not be altered in any way; the beneficiary is always entitled to payment under the standby solely from the issuer as long as the terms and conditions of the standby are adhered to in full.

CHAPTER 12

Types and Uses of Standby LCs

12.1 THE TYPES OF STANDBY LCs

The types of standby LC classified according to their purpose are:

12.1.1 Direct pay standby LC

An undertaking of the issuer to pay the beneficiary a sum of money directly upon demand. It does not necessarily have to be linked to a default situation. This type is normally issued by banks at the request of governments and central banks upon the issuance of debt instruments such as bonds, bills … etc. The issuer guarantees to pay the holder of the instrument the principal amount or the interest or both upon redemption.

12.1.2 Retention money standby LC

The undertaking of the issuer covering contracts which call for withholding a proportion of each payment until the project is completed and accepted by the contracting buyer/project owner, sometimes up to 12 months after completion. The guarantee enables the contractor to receive the full amount of each payment whilst assuring the buyer/project owner that the funds will be callable if the contractor fails to fulfil his obligations. Normally, retention money standbys are subject to prior approval of the bank's top management.

12.1.3 Bid/tender standby LC

An undertaking by the issuer to compensate the beneficiary if the applicant fails to accept a contract awarded by a bid/tender.

Contracts for major development/construction projects are awarded following the results of competitive tenders the participation in which requires

the submission of a tender standby letter of credit or a letter of guarantee issued by a bank for a percentage of the total contract amount, that is, a proportion that varies between 5 and 15 per cent of the project's total value.

Since the tender standby represents the bank's undertaking issued at the request of the tendered, the bank is obliged to pay the amount available under the standby LC to the beneficiary (the party inviting the tender) if and when the tenderer (applicant) fails to accept the contract awarded to him. This is done after the beneficiary submits a statement notifying the bank of the default of the tenderer and claiming payment (drawing on the standby LC).

The object of the tender standby LC is to assure the party inviting tenders that it will not be wasting its efforts and money in evaluating tenders from various parties; it also protects the beneficiary from losses that may result from ignoring what could be profitable offers submitted by other participating tenderers.

To reiterate, a tender standby letter of credit stipulates that the bank is liable up to a stated amount and that it will pay such total amount on demand upon the submission of the beneficiary's claim informing the tenderer that the contractor has failed to accept the contract awarded to him. Of course the banks takes a counter indemnity from the tendered usually secured by a tangible security.

12.1.4 Performance standby LC

Upon being awarding the tender, the tenderer will be required to issue a performance standby LC to assure the project owner that in the event of the contractor (tenderer) failing to fulfil his commitments within the period stipulated in the contract that compensation will be due from the bank issuing the performance instrument.

Under the performance standby LC the bank guarantees that the project owner/employer will be paid for any claims it makes in the event the contractor/tenderer defaults in completing the project up to the total amount guaranteed, if and only if said claims are made during the validity of the standby LC and in compliance with its terms and conditions.

The large amounts of these contracts warrant the presentment of a bank undertaking to guarantee performance during the various stages of the projects. Should the contractor fail to consummate the project or any phase thereof, the standby LC can be drawn on (called upon) and the bank will then pay the value of the drawing that could be a vary large amount. The bank will naturally reimburse itself by debiting the tenderer's account or realizing any held securities. Hence, the bank must be satisfied as to the financial standing of the tendered and its technical and managerial ability to complete by the project successfully.

Whether a security need or need not be demanded by the bank for issuing a performance standby LC, remains a decision of the bank that is normally taken based on the customer financial standing and its relationship with the bank.

As for every standby LC, it must have an expiry date (see Sections 4.13, 4.9, 10.1 and 10.2). In certain countries like the United States of America, the issuance of a standby letter of credit is subject to special conditions.

To summarize, a 'Performance Standby LC' is an undertaking to compensate the beneficiary for losses arising from the default of the applicant to fulfil a duty previously agreed upon with the beneficiary in an underlying contract. An example is a contractor who undertakes a major construction project as we shall exploit lengthily in the upcoming sections of the chapter.

12.1.5 Advance payment standby LC

An undertaking by the issuer to cover the beneficiary for an advance payment previously made by the latter to the applicant in case the applicant defaults to fulfil it part of a pre-signed agreement.

Some contracts, particularly civil engineering contracts, provide for an advance payment to be made to contractors to enable them to buy the project's necessities such as machinery, material etc. The contractor can only receive this payment upon arranging for the issuance of an advance payment standby letter of credit, by a bank, in favour of the owner, undertaking to repay the sum of money advanced out of the progress payment. Progress payments depend on the performance of the contract which creates a certain similarity between these and the performance guarantees outlined below.

12.1.6 Commercial standby LC

A 'Commercial Standby LC': The undertaking of the issuer to compensate the beneficiary for goods it shipped or services it rendered should the applicant default in paying by other means previously agreed upon with the beneficiary.

In commercial LC, the goods provide extra security for the bank which only delivers the documents of title necessary for the applicant to clear/receive the goods once the applicant settles the value of the letter of credit; As long as the transaction is not settled, the bank can either sell the goods or keep hold of them under its custody until the applicant settles. Of course selling the goods by the bank can be done if the bank owns the goods. The bank owns the goods if the transport document is a document of title (Marine/Ocean Bill of Lading) or if it has a court order to do so. In all other cases the bank can not sell the goods. The circumstance governing commercial standby LC of course are different.

12.1.7 Counter standby LC

An undertaking of the issuer guaranteeing the issuer for issuing a separate standby or a bank guarantee at the request of the issuer of the counter standby.

12.1.8 Financial standby LC

An undertaking of the issuer to compensate the beneficiary should the applicant fail to repay borrowed money.

12.1.9 Insurance standby LC

An undertaking of the issuer supporting the applicant's insurance or reinsurance commitments towards its clients. Normally this type of undertaking is a revolving one or evergreen.

12.2 PERFORMANCE STANDBY LC VS. PERFORMANCE BONDS

Standby LC and bank guarantees issued in relations of a performance undertaking are both practically and legally identical, hence, the reference in this section to standby LCs equally applies to bank guarantees.

A standby letter of credit is a financial instrument used to compensate the beneficiary, in part or in whole, for losses incurred as a result of the applicant's failure to perform a duty previously agreed upon with the beneficiary in a legal contract that depicts the underlying transaction which gave rise to the standby letter of credit. This means that the beneficiary receives a sum of *cash* money available under the standby letter of credit upon drawing on it. It is left up to him then to complete the project covered by the credit.

In contrast, the infamous American performance bonds issued by surety are distinctively unique in that they not only guarantee the performance of the contractor but also the actual completion of the project to its owner, that is if the contractor defaults the surety simply completes the construction of the project in its totality up to the available sum of the bond. Then one may ask why would anybody need a standby letter of credit that may not ideally cover the damages suffered upon the default of the contractor when there can be a performance bond that will deliver the full project upon the contractor's default? Let's have a closer look at both instruments.

A rudiment of trade finance practice is knowing that the actual reason for issuing a standby LC or a surety bond is its effect in driving the contractor to perform well in order to avoid any disputes with the owner which

may eventually lead to draw or call on credit or bond as the case may be. For the contractor, the effect of such action would be devastating not only in terms of financial losses, but also on the reputation of the contractor which literally means that the contractor would not be able to enter the market again.

Other than the one mentioned earlier, there are other differences between the two instruments. The volume and number of surety bonds are much lower than those of standby LCs, however, one can not ignore the vast major projects covered by performance bonds, for example, on a recent offshore oil platform project in Brazil, two major U.S. sureties jointly issued multi-million dollar performance bonds to guarantee the performance of the contractor. Nevertheless, the standby LC is the more preferred instrument for the major projects. There are a host of reasons for this, the most important of which is that the standby LC can be drawn on simply by presenting documents which are well within the beneficiary's control. The issuing bank, confirming bank or a nominated bank acting upon its nomination is obliged to honour the beneficiary's demand provided the presentation is a compliant one. The possibility of preventing payment of a compliant demand is slim to none. Even a court of law will not instruct the bank to halt payment to the beneficiary unless there is a clear and undoubted case of fraud.

In contrast, under the American surety ship, the owner must first persuade the surety that the contractor has defaulted and as such the bond is due for execution. The surety then will have to investigate the claim to determine its merit which could take up to three months in total with all the wasted time for the owner. If the surety objects to the owner's initial request, the owner must then pursue legal action to compel the surety to honour its obligations under the bond. During any such litigation, the surety retains the proceeds of the bond, and the project suffers more delay. Needless to mention about the possibility of failure of the owner's law suit. As such, the standby LC remains the preferable instrument since the surety tends to find means to avoid liability. Even where the surety accepts liability, it will still take time to investigate the default of the contractor and determine a suitable work plan to finalize the construction; the delay could mean an extra high cost for the owner. The surety ship may best suit an owner with little experience in construction.

In contrast, the protection afforded by a letter of credit is ideal for the owner with experience in construction. The owner then would be able to act much faster and effectively under a credit than a surety, and thus promptly complete the construction.

In cases of default, the construction contracts usually force the contractor, upon default, to assign the project's subcontracts to the owner. The owner would then be able to quickly take over all of the responsibilities itself and act in the interest of the project. It could even direct the defaulting

contractor to assign the subcontracts to a third party acting on its behalf, and thus continue the project. The value received under the standby LC upon drawing on the contractor's bank once the latter default's would compensate the owner for the costs incurred by the owner whilst taking over the project and other similar cost.

12.3 EVERGREEN AND ANNUALLY RENEWABLE CREDITS

This is a special type of standby LCs, occasionally referred to by revolving standby, normally used in situations where the beneficiary is an agent of the applicant and has a duty to act on behalf of the latter before the clients of the former. For example a major German insurance company (Applicant) instructed their bankers to issue a standby LC in favour of their agent in Lyon, a local French insurance company (beneficiary), undertaking to honour all claims made by the French beneficiary in recovery of accidental compensation amounts paid by the French beneficiary to clients who insured their cars with the German insurance company.

Notice here that it is almost impossible to quantify or determine the amounts available under the LC. This is because it often takes a long time that could reach up to several years to quantify the liability of each transaction such as in cases of car accidents discussed earlier. As such, these credits have much longer validity periods and can not be amended or cancelled before the issuer gives a prior notice to the beneficiary well before the cancellation; such notice is normally given a month ahead of the cancellation.

The following is an example of a standby LC that depicts it evergreen nature:

This evergreen standby letter of credit shall automatically revolve for a further year, without a written amendment, on the first day of January of every year from the day it is issued, in such a way that it is constantly available for a minimum period of 3 years unless a notice of cancellation or amendment is given in writing at least 30 days prior to the 31st day of December of the first year of the current validity period. This notice must be duly signed by the issuer, given in writing and delivered by registered mail.

Due to the risk factor, banks normally refrain from issuing such credits unless they are confident that they will be reimbursed for any amounts paid as long as the credit is outstanding since the validity period in this case is much longer than other types of credits.

Issuers normally arrange for booking a security that has a value adjacent to that of the credit liability during the full period of the standby. This is to protect the bank against any deterioration in the value of the security.

Furthermore, issuing banks need to be cautious that the procedures for recording and monitoring the banks' liabilities (risks) under these annually renewable credits are well controlled over the whole lengthy period of the standby.

In view of the risks associated with issuing these revolving credits, banks would only accept to issue them for those clients of solid financial standing and clean reputation in the trade cycle.

It remains to recall the provisions of Rule 2.06 (a) on revolving or evergreen standby LC. The subrule stressed that if a standby is subject to an automatic amendment by an increase or a decrease in the amount available, an extension of the expiration date, or the like, the amendment is effective automatically without any further notification or consent beyond that expressly provided for in the standby.

12.4 PERFORMANCE STANDBY LCs FOR CONSTRUCTION PROJECTS

12.4.1 Background

The number of construction projects in the world today is amazingly high. In each and every country, multinational firms and governments actively seek to execute large construction contracts which include towers, schools, convention centres, universities, buildings, sports stadiums, museums, hotels, bridges, airports, highways, bridges, tunnels, power plants … etc. The extensive cost of consummating these projects in addition to the enormous risks endured are only a few of the reasons that make large construction projects a complex process.

12.4.2 Performance standby LCs and construction projects

Pursuant to our introductory discussion in Chapter 2, this section focuses on performance standby LC in major construction contracts. It is well understood that the owners of comparatively large construction projects, assign these projects to international reputable contractors who not only enjoy strong financial standing, but also a very good reputation of being technically well versed and ethically reliable. The owners would investigate the contractor's history, past performance, previous professional achievements, management and financial statements. In addition, the owners take into consideration the inherent operational and political risks that could cause any contractor to default in delivering the project as required.

Project owners in America frequently request a performance bond issued by a surety as a security measure to guarantee the delivery of the project. The surety guarantees complete performance on the underlying construction contract in case of default. Albeit this, the surety features so many legal defences to liability to the extent that owners may actually lose the protection they sought in the first place against the default situation. It is for this reason that contractor performance in major construction projects is usually secured by either a standby letter of credit or a bank guarantee. Both instruments are made available by simply drawing on the issuer under the instrument, by presenting a draft and a demand. The issuer will promptly honour the owner's (beneficiary's) demand by paying a fixed sum of money on demand, provided that the owner's presentation strictly complies with the terms and conditions of the instrument (either the standby LC or the guarantee). The issuing bank will not be required to check beyond the face of the presentation in order to authenticate the facts and details represented by the documents constituting the presentation except where there is a clear and undoubted case of fraud. Unlike a surety, the issuing bank will not assist the owner in completing the project. As such, these instruments may not be suitable for the owner with little technical knowledge in the construction sector; however, for the expert project owner they may provide ideal protection.

12.4.3 The risk factor

The complexity of the construction process stems from the fact that it is almost impossible to control the natural elements or the socio-political factors of the external environment in which the construction process takes place; the risks of war, strikes, earthquakes, hurricanes, negligence of workers, political extremists … etc. are always attendant in any project. In addition to the hindrances of constructing outside, time constraints are a challenge in itself. Projects need to be delivered within a specific time frame and need to be done accurately at the first time. The management of the large number of workers involved in large projects also adds to the risk factor; management in itself is a complex discipline. In one Italian project more, than 5900 workers were apparent on the site together with 27 different companies including engineers, architects, contractors, subcontractors, equipment manufacturers, material suppliers, carriers, freight forwarders, financial institutions, and insurance companies. Some of the participants are experienced construction professionals, but others are not. The default of any one of these participants to fulfil their obligations, or opposition from governments, non-governmental organizations, labour unions, or community groups, can endanger the whole project or simply put an end to it. Put it simply, the associated risks which are arduously

surmountable, can be classified into the following categories:

1. Financial Risk of the Contractor: The risk of the contractor going insolvent is the most fearful danger of any project. The default of the contractor would halt the entire project and create operational crises that may lead to withdrawal of the projects subcontractors; suppliers would also cut necessary supplies; and banks will execute whatever securities they maintain as a precautionary measure. At a minimum, the owner will face delay and increased costs.
2. Technical Risks; these include design errors and construction defects.
3. Acts of God; such as weather, earthquakes, volcanoes, floods, tornados, tsunamis, heat, ice/snow, humidity … etc.
4. Labour Risks; such as civil commotions, strikes, lockouts, work slowdowns, insurrections, riots … etc.
5. Human Risks; such as corruption, vandalism, theft, job site safety, and disease.
6. Design and Technology Risks; Trying new technology, materials, or processes.
7. Site Risks; subsurface conditions, environmental contaminations, endangered or protected species, archaeological or anthropological discoveries.
8. Logistics Difficulties; congested urban areas, remote isolated sites.
9. Supplier and Transportation Risks; material shortages and delivery delays
10. Regulatory Risks; complex government permitting and approval processes.
11. Financial Risks; cost of capital, inflation, and taxes.
12. Political Risks; war, terrorism, government intervention, such as wage and price controls.
13. Legal Risks; associated with foreign projects include working in a multicultural environment; language barriers, border entry requirements, foreign exchange risks, taxation and legal disputes arising in multiple jurisdictions.

The owner of such a project would therefore require a means of protection against the perils that may be incurred as a result of the contractor's default or the materiality of any of the risks stated above.

12.4.4 The similarity in the role of performance standby LCs and guarantees

Through out Chapter 2 of this book, we have been focused on explaining the function of performance standby LC as an effective means to provide a financial security for the beneficiary (owner of the project) if and when the applicant (contractor) defaults to deliver the project as agreed. We also explained the similarity between the bid/tender standby LCs and guarantees; both instruments are often used like bid bonds to guarantee that bidders will execute the construction contract if and when they are awarded the bid. If the successful bidder refuses to enter into the contract, the owner may draw on the guarantee or standby credit.

Same as the infamous *American* bid bonds, bid/tender guarantees or standby credits are issued in fixed values that could reach up to 10 per cent of the tender amount. The main difference between the bid bonds and a standby LC or guarantee is that under the latter the owner will receive the full value of the instrument; regardless of the actual damages it has suffered.

To reiterate, the owner prefers a standby letter of credit or possibly a bank guarantee to protect itself against the risks of the contractor's default of performance in case of performance standby LCs/Guarantees, and also prefers a bid/tender standby LC or guarantee as a security to ensure that the contractor once awarded a bid will execute it.

These two instruments are truly invaluable for the owner because they are available on demand normally by the presentation of a simple written paper requesting payment (demand) and a draft; of course other documents may be required to effect payment but those are all within the means and under the control of the beneficiary.

Performance or bid standby LCs and guarantees both constitute a contingent liability on the bank, that is, they remain off balance sheet until a complying presentation including a demand is drawn under any of the instruments as appropriate. At such time they enter the balance sheet as an actual liability. The accounting treatment of these two instruments is in principle identical to the treatment of commercial LC.

Each bank has a different criteria set to approve the issuance of standby LC or guarantees. In fact contractors are normally awarded a credit line – as part of the customer's over all credit position that also includes an OD, import/export loans, commercial loans … etc. – with specific limits within which they are allowed to issue standby LCs, guarantees and/or commercial LCs. These lines, or the overall position of the customer, are granted after the completion of a full systematic process of evaluation for the relationship that includes an analysis of the reputation of the customers in the international and local trade cycles, the financial standing, financial statements, cash flows, in addition to the adequacy of the securities (mortgage, collateral, guarantee,

cash lien … etc.) the bank will maintain against granting of said credit facilities. Major reputable banks would not issue a standby LC on a case by case basis outside a whole relationship regardless of whether or not the applicant/contractor offers full cash coverage that equals or exceeds the value of the instrument.

Hence, a contractor who presents a standby LC to the owner is implying that its credit worthiness in high and as such is a source of comfort to the owner.

Many banks, unlike the surety ship, hardly examine the practical skills of the contractor and its ability to technically complete the complex construction project. Hence, the contractor's presentation of a standby LC or guarantee is not an indication of the contractor's level of technical skills and as such must not be relied upon in assessing the technical ability of the contractor during qualifying the various bidders for the construction project at the selection phase.

12.4.5 Performance bond – surety

Performance bonds are the most common financial instrument used in the American construction industry. In general, the process of issuing a Performance Bond involves an independent company (a surety company) who definitely undertakes to the owner of the project (Obligee) to guarantee the completion of the underlying project if the contractor defaults to do so. Performance bonds are normally issued for the full value of the contract or the project. The undertaking of the surety company in case of default is included in the text of the bond and depends on its precise language. Said undertakings commonly include the following obligations:

1. Financing the contractor in case it goes insolvent so as to guarantee the successful completion of the project.
2. Employing or contracting new contractors to ensure the continuity and successful completion of the project.
3. Allowing the owner a 'Buy the Bond Back', that is, paying the obligee due on the bond. This can only be done if the amount due is less than the cost of completing the project by other means.

For it to be effective, the obligee must provide notice of default in good time or draw a claim in accordance with the bonds terms and conditions. Other contractual terms include the necessity that owners present sound and comprehensive rather than defective plans, consequences of terminating the contractor by the owner, the consequences of failure of the owner to provide information necessary to complete the project or allow access to site … etc.

A surety bond is a legal topic rather than a banking one. It was generally introduced in this chapter due to the similarity of its functions to those of the standby LC and letters of guarantees. The point worthwhile remembering is that the surety has so many defences to liability that the owners may actually lose the protection they sought in the first place against the default situation. It is for this reason that contractor performance in major construction projects is usually secured by either a standby letter of credit or a bank guarantee.

12.4.6 The practicality of guarantees and standby LCs

In almost all the countries around the globe, the standby LC and the guarantees are the most acceptable tools to guarantee the performance of the contractor. The only differences that distinguish one instrument from the other is that the standby letter of credit has evolved to encompass a much wider scope of uses than that of the LC, in addition there is a type of standby LC called 'Direct Pay' which allows the beneficiary to simply draw money under the standby, a function which the guarantees do not undertake. Albeit these two differences, standby LC and performance guarantees, legally and practically, constitute perfect substitutes, that is, they are ideally similar. Both instruments represent the issuing bank's undertaking to pay the beneficiary on demand the sum available under the instrument. The bank honours/pays the drawing only if the beneficiary presents to the issuing bank the set of documents stipulated by the relative instrument strictly complying with its terms and conditions and also adhering to the governing rules if any, that is, the ISP98 in case of standby LC and the URDG in the case of a demand guarantee; both sets were inaugurated by the ICC in Paris.

Once the owner draws on the standby or guarantee, the issuing bank will examine the drawing, that is, the presentation of the stipulated set of documents against the terms and conditions of the instrument and thereafter pay the beneficiary if the documents were fully conforming to the instruments stipulations. Upon honouring the documents the relationship between the issuing bank and the beneficiary/owner ends with regards to the transaction in question. This means that an issuing bank will not interfere with the project and the owner would solely be the party responsible for its completion. The issuing bank will naturally reimburse itself by debiting the applicant's account with the full value paid to the beneficiary in addition to its charges, if any.

12.4.7 Reasons for popularity

Standby LCs have evolved over a very long period of time to accommodate the need of businesses for a secured and liquid financial instrument to

enable commercial and financial deals. Standby LCs and guarantees are both secured because they represent the undertaking of a bank to pay. They are also liquid because they are available by simply presenting a set of compliant documents to the bank, and the bank will honour the value of the documents presented without actually investigating these documents beyond their face. For example, if a copy of the commercial invoice states that the goods comprise of 700 cartons of Russian Crystal, the bank is not required to physically inspect the cartons to ensure that they actually contain Crystal glasses, and hence the LC is conveniently liquid. It is often the case that the beneficiary only requires a simple *demand* and a *draft*, both of which are prepared by the beneficiary himself, in order to draw on the standby LC or the guarantee and receive payment thereafter.

12.5 INOPERATIVE STANDBY LCs

Occasionally, the applicant seeks to include in the text of the standby credit a term that makes payment under it dependent on the presentation of a document or a set of documents signed or issued by the applicant itself in addition to those traditional documents that need to be prepared by the beneficiary whenever it draws on the authorized bank. This means that the beneficiary's claim can only be honoured if the applicant allowed so.

A standby LC of this nature is called inoperative and it is almost always drafted to the detriment of the beneficiary. Due to lack of technical knowledge, many beneficiaries often fail to spot the significance of the term and only realize they were trapped once they present their first drawing. The significance of standby LCs is that they should be made available for payment against the presentation of a simple demand and a draft regardless of disputes or objections.

Banks have an ethical duty rather than a legal one to warn the beneficiary of the inoperative term and explain how it does demean its position.

CHAPTER 13

Roles and Responsibilities

13.1 THE MECHANISMS OF THE STANDBY LETTER OF CREDIT

The standby letter of credit involves numerous parties all of whom act within a range of fixed liabilities precisely set by the ISP98. The roles and responsibilities of the various parties to the standby letter of credit transaction are the subject matter of this chapter.

The cycle of the standby letter of credit illustrated in Figure 13.1 below may be generally summarized in the following steps which should be tracked on Figure 13.1.

The standby letter of credit is issued by an issuing bank (the issuer) upon the instruction of one of its customers, the applicant, in favour of the beneficiary. The letter of credit may be advised to the beneficiary either by the issuer directly, or by a third bank called the advising bank and is made available with a nominated bank, which may be the advising bank or another different bank.

Once the issuer makes the standby LC available with a third bank, we name this third bank a nominated bank.

The advising bank is usually the same nominated bank though not necessarily so, that is, the credit may be advised by a third bank and at the same time is made available with this same third bank. If the bank accepted its nomination, we normally refer to it as the nominated bank acting upon its nomination, that is, it becomes the agent of the issuer. Nevertheless, if the bank elects not to accept its nomination, we refer to it as the advising bank where it merely acts as a post office between the beneficiary and issuer without undertaking any liability under the transaction, that is, it only delivers the standby LC to the beneficiary and dispatches the beneficiary's documents to the issuer without any responsibility on its part.

Hence, the nominated bank is a bank requested/authorized by the issuer to honour the beneficiary's claim upon drawing on the standby, provided the

beneficiary's presentment is compliant with the terms and conditions of the standby. The nominated bank may elect to act upon its nomination by accepting to receive the beneficiary's claim on behalf of the issuer. Upon receiving said claim, the nominated bank has two options: either to honour the presentment if it was made in compliance with the credit stipulations and thereafter claim reimbursement per the credit terms, or alternatively it may decline the documents and thereafter return them to the beneficiary if they were found to be discrepant. (See Section 3.4, Rule 2.04 of the ISP98 Nomination). Acting on its sole discretion, the nominated bank could allow the beneficiary to cure the discrepancies in the documents and represent them again if this is possible within the timeframes (validity) allowed by the credit itself.

If the documents were found to be compliant, the nominated bank will then honour the beneficiary's claim and dispatch them to the issuer, claiming reimbursement for the value paid in addition to any charges due. The bank from which the nominated bank claims reimbursement is called the reimbursing bank.

The issuer will then re-examine the documents and if it finds them to be compliant it will reimburse itself from the beneficiary or otherwise it will notify the nominated person from whom the documents were received. If reimbursement was already made, the issuer will request the nominated bank to return the full amount received with any due interest.

Occasionally, the beneficiary may request that the standby be confirmed by a bank other than the issuer. A bank that accepts to confirm the standby is called the confirming bank or the confirmer (see Section 3.1 Rule 2.01 (d) of the ISP98).

The confirmer's obligations are similar to those of the issuer and as such it would be required to act upon receipt of the beneficiary's claim or presentation in the same manner as the issuer. To summarize, the parties to a standby letter of credit are:

- Applicant
- Issuer
- Beneficiary
- Advising Bank
- Nominated Bank
- Confirming Bank
- Reimbursing Bank

This chapter aims at explaining the role of each of the parties to the standby letter of credit and responsibilities that stem there from.

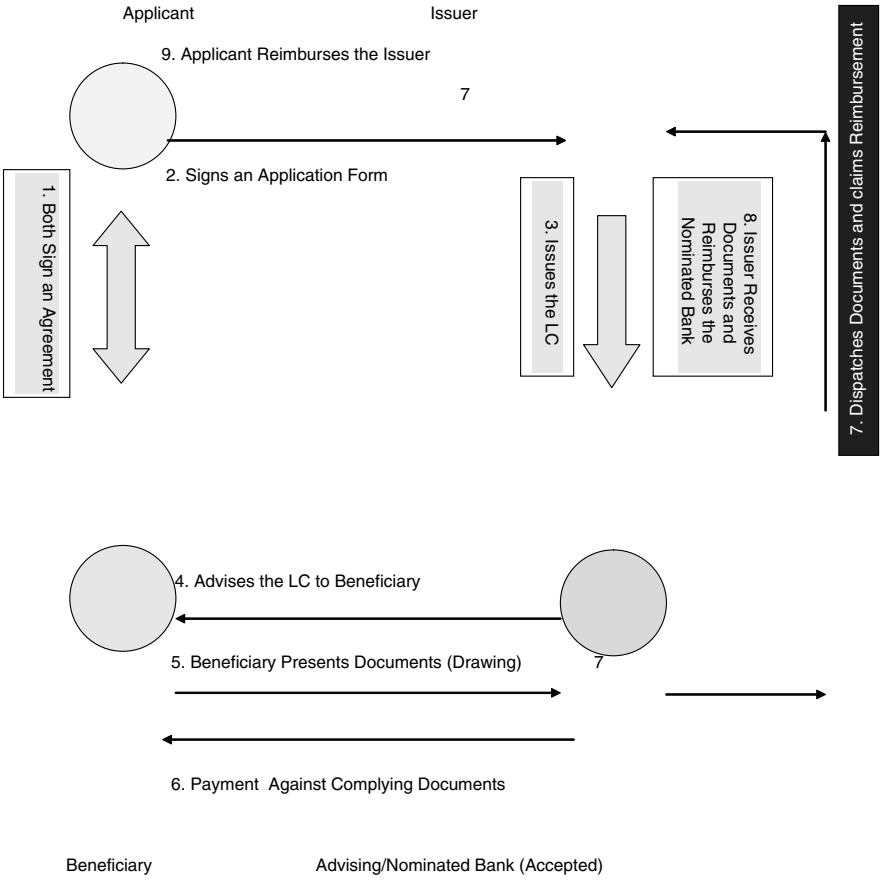

Figure 13.1 The mechanics of the standby letters of credit

13.1.1 General procedure outlined

Figure 13.1 above depicts the steps generally followed in completing any standby letter of credit transaction. These basic steps are:

1. The applicant and beneficiary enter into a contractual relationship and agree to either secure a default situation or arrange for payment by means of a standby letter of credit.
2. The applicant instructs its bankers to issue a standby letter of credit in favour of the beneficiary undertaking to pay an amount of money upon presentation of documents which conform to the credit terms and conditions.

3. The issuer issues the credit and sends to the beneficiary through an advising/nominated bank.
4. The advising/nominated bank accepts its nomination by the issuer to act as the agent of the latter and then advises the credit to the beneficiary (pass over the original standby to the beneficiary).
5. The beneficiary draws on the credit by presenting the stipulated documents exactly as demanded by the credit terms and conditions.
6. The nominated bank acting on its nomination checks the documents and ascertains that all the credit stipulations have been fulfilled and thereafter pays the credit value to the beneficiary (or undertakes to pay if the credit is available in any method other than sight payment).
7. The nominated bank dispatches the documents to the issuer and claims reimbursement for the amount paid in 6 above.
8. The issuer checks the documents to determine that these comply with the credit terms and conditions and thereafter reimburses the nominated bank acting upon its nomination.
9. Issuer debits the applicant's account in reimbursement and delivers the documents to the applicant thereafter.

The above process is generally stated to simplify understanding the various roles and responsibilities of the parties to the standby letter of credit transaction. In the following sections of this chapter we will tackle the process depicted by Figure 13.1 above in more details so that we can acquaint ourselves with the complex issues encountered in real life transactions.

13.2 BONDS CORRELATING THE PARTIES

The integrated bonds that correlate the principal parties to the standby LC are ubiquitous in the international system of payment which they constitute. Prior to discussing these relations, it is mandatory to understand that the issuer of a standby letter of credit is obliged to reimburse any bank which has taken up the documents of the beneficiary and thereafter paid the latter upon the proper authorization of the issuer and in accordance with the provisions of the ISP98 as we discussed earlier in the previous chapters. These relations can be illustrated as follows:

A. The applicant and the beneficiary: Upon signing a contract to sell the buyer/beneficiary services or goods, the applicant will arrange for the

issuance of a standby LC through its bankers as a form of security by which the beneficiary is allowed to either draw on the LC in a default situation or availed of a direct payment process, for example, payment of principal, interest or both in cases of securities such as treasury bonds.

B. The applicant and the issuer: The issuing bank issues the standby letter of credit upon the request and at the authorization of the applicant. The issuer does so within the limit boundaries of its relationship with the applicant. Reputable banks seldom issue a standby LC to a walk-in customer; they always set a whole relationship which also includes a limit for issuing standby LC to the applicant. Such relationship is based on detailed study of the applicant's financial position, in addition to its professional stature, reputation and the securities provided, that is, mortgage, lien, guarantee … etc.

C. The issuer and the beneficiary: The issuing bank undertaking is directed to the beneficiary who can oblige the former to honour by presenting compliant documents. This is because the issuer's undertaking represents its legal commitment to pay the value of the standby letter of credit upon the receipt of the documents indicated by the LC in accordance with the terms and conditions of the credit.

   The beneficiary may or may not be located in the same country as the issuer.

D. The issuer and the corresponding bank: In cases where the beneficiary is located in a foreign country, the issuer then can advise the credit either through its own branches in that country or through a third bank if it doesn't have a branch there. This third bank is called the correspondent. The issuer has an agreement with its correspondents to cooperate in various banking divisions including. This agreement is referred to by the Agency Arrangement. Each bank has Nosto and Vostro accounts to facilitate the settlement of transactions.

   In LCs transactions, the correspondent bank is referred to by different names depending on the function it will perform under each specific transaction. These different names and the relative circumstances surrounding them are:

   i. *Advising bank*: This name is given to the correspondent bank if is acting merely as an advising bank, that is, it resembles a post office by delivering the LC instrument to the beneficiary and dispatching the documents received from it to the issuer. As such, the credit is available with the issuer who would honour the presentation value

upon examining the documents and ensure that it is compliant, afterwards, it effects payment to the beneficiary.

ii. *Paying bank*: If the correspondent bank is nominated by the issuer to pay the value of a credit available by sight payment or deferred payment and such nominated bank accepted the nomination per the provisions of Rule 2.04 of the ISP98 which we discussed earlier in Chapter 3, it will be referred to in this case by the Paying Bank.

The bank paying upon receipt of documents, will check them and if these are found to be conforming to the credit stipulations, that is, do not contain any discrepancies, the paying bank will pay the beneficiary directly – either at sight or at a future deferred date – the value of the documents (less fees and charges if these are for the beneficiary's account or the full value of the documents if these are for an applicant account). Afterwards, the paying bank will claim reimbursement from a third reimbursing bank assigned by the issuer or directly from the issuer itself.

iii. *Accepting bank*: When the correspondent bank is nominated by the issuer to pay the value of the credit available by acceptance (i.e., a draft must be presented with the documents), and the nominated bank has accepted its nomination per the Rule 2.04 of the ISP98, it will be referred to by the Accepting Bank.

The responsibilities of the Accepting bank are identical to those of the paying bank with the exception that the Accepting bank can honour the value of the documents if and only if the documents contain a bill of exchange/draft, that is, presenting a draft is mandatory under standby LCs available by acceptance whilst they may or may not be presented in other types of standby LCs.

Upon receipt of documents, the Accepting bank will check them and if these are found to be compliant with the credit terms and conditions, that is do not contain any discrepancies, the paying bank will accept the draft and thereafter pay the beneficiary directly (either at sight or at a fixed or determinable future date) its value (less fees and charges if these are for the beneficiary account of the full value of the documents if these are for applicant account). Afterwards, the paying bank will claim reimbursement from a third reimbursing bank assigned by the issuer or directly from the issuer itself.

iv. *Negotiating bank*: If the correspondent bank is nominated by the issuer to negotiate the value of the credit available by Negotiation (see Rule 2.01, Section 3.1), and the negotiating bank accepted to

act as such, then it will be referred to by the negotiating bank. In certain countries, a negotiating bank is also used to describe the bank that merely handles the documents without any responsibility on its part, hence, it can be said that the term negotiation could have two meanings; as such, it is essential to distinguish the term by correlating it with the responsibilities of the correspondent bank.

Upon receipt of documents, the negotiating bank will check them and if these are found to be compliant with the credit terms and conditions, that is do not contain any discrepancies, the paying bank will negotiate the documents and thereafter pay the beneficiary directly (either at sight without recourse to the beneficiary (2.01 (b) (iii)) or at a fixed or determinable future date with or without recourse depending on the agreement with the beneficiary) the presentation value (less fees and charges if these are for the beneficiary's account or the full value of the documents if these are for applicant account). Afterwards, the negotiating bank will claim reimbursement from a third reimbursing bank or directly from the issuer itself.

Credits available by Negotiation (see Section 3.1 in Chapter 3 – Obligations)

'Subrule 2.01 (iii)' addresses a situation where the issuer honours 'by negotiation'.

Typically, this situation arises when the standby requires that the draft be drawn on the applicant. In all other cases involving a draft, the issuer honours by paying or by accepting and paying, depending on who is the drawee. When the draft is drawn on the applicant, the issuer honours if the issuer endorses it without any right of recourse on the documents or on the draft and subsequently pay. When the draft is drawn on the issuer, a confirmer honours by purchasing the documents, by paying a sight draft, or undertaking to pay a time draft without any right of recourse on the document or the draft against the beneficiary or a nominated person who has paid. In the case of a time draft, the issuer may or may not be liable depending on the provisions of the standby letter of credit.

Confirming bank: If the issuer requested the correspondent bank to add its confirmation to the credit and the correspondent bank agreed to confirm the credit, then it will be called the Confirming Bank. The responsibilities of the confirming bank are consistent with the issuer's undertaking.

In summary, in LC transactions the correspondent bank is referred to by different names depending on the function it will undertake under each specific transaction; it can be an Advising Bank, Paying Bank, Accepting Bank, Negotiating Bank or Confirming Bank.

13.3 ROLES AND RESPONSIBILITIES – APPLICANT'S SIDE

A1. Applicant and beneficiary

13.3.1 Background

13.3.1.1 The concerns of the beneficiary

The standby LC today is a basic financial and commercial instrument often issued for vast amounts that could reach up to $50 million and even more in major construction projects. From the beneficiary's perspective, the standby LC is the device that provides the security it needs to protect it mainly against the default of the applicant. Nevertheless, in all circumstances surrounding major projects, the beneficiary prefers to have the project at hand completed rather than drawing on the standby. This is because the standby seldom compensates the beneficiary for the full amount of cost practically needed to complete the project upon the default of the applicant; the applicant default could mean heavy financial loss and a waste of valuable time even after the standby LC is drawn upon. This is especially true in civil engineering cases where the amount of standby LC covers only 5–10 per cent of the transaction. Occasionally however, the instrument is found to be sufficient to compensate for damages incurred, the detriment here remains the opportunity cost or the real cost of the wasted time, effort and money that could have been employed in a second best choice.

It is said and accurately so, that the best protection against the applicant's default is to ensure that the applicant/contractor/tenderer/seller selected is a genuinely skilled competent professional with a bright past performance/history and strong financial capabilities to complete the job.

On large projects, applicant/contractor/tenderer/seller (hereinafter referred to by the applicant) performance is usually guaranteed by either a standby letter of credit or bank guarantee. These instruments will promptly pay the beneficiary/owner/buyer (hereinafter referred to by the beneficiary) the available amount of money on demand, provided that the beneficiary's presentment strictly complies with the terms of the credit. The issuing bank will not investigate beyond the face of the documents, into the facts pertaining to the underlying contract, except of course in the case of fraud. The issuing bank will not assist the beneficiary in completing the project; it will merely honour its demand. As such, the standby LC may not be suitable for the layman beneficiary who lacks practical experience and technical knowledge; however, for the expert beneficiary, standby LCs are just exemplary.

13.3.1.2 The concerns of the applicant

Once again, standby LCs are often issued for large amounts that can have devastating effects on even large companies. An LC for $20 million dollars, for example, if drawn upon may well cause a bankruptcy for the applicant, especially that the issuer is bound to honour the drawing of the beneficiary by the mere presentation of a simple demand and a draft in most cases. Hence the applicant's main concern is to exert rigorous and focused effort to avoid any situation that may lead the beneficiary to draw on the standby.

Simply put, the actual protection provided by a standby LC is psychological and lies in its effect of driving the applicant to perform well in order to avoid any disputes with the owner which may eventually lead to draw or call on the credit. For the contractor, the effect of such action would be devastating not only in terms of financial losses, but also on the reputation of the contractor which literally means that the contractor would not be able to enter the market again. It has even been said that a draw on a standby LC is usually tantamount to a death sentence for the contractor.

Another concern of the applicant is a false or fraudulent drawing by the beneficiary, depending on the size of the credit, a sudden demand for reimbursement by the bank upon a false or fraudulent drawing made by the beneficiary can create an immediate insolvency and would cause the applicant a bankruptcy. The contractor is vulnerable when its performance is guaranteed by a standby letter of credit and as such, the contractor is usually cautious to evaluate the beneficiary prior to entering a tender or an agreement with the latter.

13.3.2 Payment under standby letters of credits

The documentary nature of the standby letter of credit is the rational behind the principle that payment under a standby letter of credit is made against documents which comply with the terms and conditions of the standby LC and the provisions of the ISP98 when the LC is made subject to them.

To clearly understand the payment process under standby LCs, we need first to carefully recall the provisions of the following subrules:

By referring to the undertaking however named or described, Rule 1.01 (b) of the ISP98 (Scope and Application) emphasizes that it is this documentary nature of the standby LC that triggers its effectiveness and not its name or description.

Rule 1.09 (a) (Definitions) identifies the applicant as the person who applies for issuance of the standby letter of credit in addition to the issuer itself when it applies for its own account and thirdly the rule also defined as applicant the person who applies in its own name for the account of another person. Hence, the issuer can also be an applicant at the same time.

Rule 2.01 (a) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) delineates the issuer's and the confirmer's obligations to pay the beneficiary, at sight or future dates, upon the presentation of complying documents in accordance with the ISP98 rules supplemented by standby practice.

Rule 2.02 (Obligation of Different Branches, Agencies or other Offices) provides that branches, offices or agencies located in different countries are treated as different banks and will function as such with regards to the standby LCs operations.

Whilst quoting the different relations between the parties to the standby letter of credit transaction, Rule 1.06 (c) (Nature of Standby) provides that the standby letter of credit is separate from the underlying contract that gave rise to it, that is, it is of an independent character.

Rule 1.07 (Independence of the Issuer – Beneficiary Relationship) also affirms the independence principle in the standby letter of credit undertaking. (See Chapter 15 Section 15.1.3 The Independence Principle).

Rule 1.06 (a), (c (iii)) and (d) indicate the independent, documentary and binding (irrevocable) character of the standby letter of credit. Once again the ISP98 stresses the fundamental principle that the credit is a documentary instrument and the actual performance or default in the underlying transaction that the standby letter of credit stemmed from.

The subrules indicated above formulate the fundamental principle under which payment is made in a standby LC transaction, that is, payment is conditioned to; (a) the presentment of the document(s) required by the standby letter of credit, and (b) the full compliance of these presented documents with the terms and conditions of the standby letter of credit and the provisions of the ISP98 if the standby is governed by them.

The remaining subrules indicate that standby LC are independent (1) of the underlying contracts they represent, and also (2) of the applicant-beneficiary relationship. The rules also emphasize that the applicant-issuer relationship is of no concern to the beneficiary.

13.3.3 The terms and conditions of the standby letter of credit

The terms and conditions of the standby LC generally denote the underlying contract previously signed by the applicant and beneficiary. This means that the terms and conditions of the standby LC are agreed upon between the two parties prior to issuance. This however, does not mean that what has been agreed is based on common understanding of the whole process; frequently the comprehension of the terms agreed upon differs between the two parties and this may eventually lead to disputes. To avoid such potential disagreements, the following conditions at least need to be clarified and

agreed upon amongst the two parties:

1. The recital of the default phrase included in the Demand made by beneficiary upon drawing on the standby letter of credit.
2. The availability of the standby credit; sight, deferred, acceptance or negotiation.
3. The currency and amount of the standby letter of credit.
4. The validity of the credit.
5. Partial drawings allowed or prohibited.
6. Stipulated Documents.

These are the minimum details that must be agreed upon by the applicant and beneficiary to the LC transaction.

13.3.4 The beneficiary and the credit

The beneficiary has a responsibility of carefully scrutinizing the terms and conditions of the standby letter of credit in order to ensure that it is able to draw on it at any time. Thus, it must be certain of its capability of presenting the stipulated documents once the need arises. It must also be certain that the terms and conditions are workable and can be fulfilled upon drawing on the instrument, that is, there must not be an inoperative clause. (also see Section 12.5 – Chapter 12 Inoperative Standby LCs.)

Furthermore, the beneficiary needs to check that the standby LC precisely depicts the underlying contract with the applicant, that is, it must assure itself that the credit has been opened in accordance with the original contract.

Put simply, the beneficiary must check the documents, the workability of the conditions and the level of correspondence between the terms and conditions of the underlying contract and the operative instrument.

Usually the risk of occurrence of numerous operational problems can be eradicated at an early stage if the beneficiary cautiously examines the credit the moment it is advised to by the issuer and in accordance with the directions outlined above.

13.3.4.1 The beneficiary and the advising bank

Sometimes, the beneficiary may have difficulty understanding the meaning and the application of many technical terms included in the standby letter of credit. This is especially true in the commercially less developed areas of the world as technical trade finance knowledge at an expert level is truly

scarce there. In such a situation, the beneficiary is advised to consult the advising bank who would normally welcome the opportunity to help the applicant.

Upon examining the credit, the beneficiary can immediately request an appropriate amendment of any terms that might be found to contravene the original terms agreed upon or render the credit inoperative.

13.3.5 The applicant and the credit

The applicant is the principal party on whose behalf the issuer undertakes to pay. The Applicant's main duty is to perform at standards adequate to prevent the beneficiary from drawing on the standby letter of credit covering a default situation, that is, to avoid default.

If the applicant defaulted, then its main duty becomes to reimburse the issuer upon the latter's payment of the standby letter of credit.

In direct pay standby LC, the applicant's duty is to avail the issuer of immediate reimbursement once the beneficiary draws on the standby LC.

13.3.6 Handling discrepant presentations

Albeit the fact that the underlying agreement between the beneficiary and the applicant is effective and that the standby letter of credit is safely drafted, the beneficiary may actually fail to present compliant documents and as such discrepancies will need to be handled accurately by the authorized bank, that is, the issuer, the confirmer, or a nominated bank acting upon its nomination. This means that in order to avoid wasting a valuable opportunity to receive payment under the standby letter of credit, the bank needs to precisely apply the provisions of Article 5 of the ISP98 which we fully interpreted earlier in Chapter 6.

13.3.7 Sound presentment of documents

The presentation of documents in a sound manner is essential to obtain payment under the standby and as such documents must be carefully examined and the presentation must be made not only in accordance with the terms and conditions of the credit itself, but also in compliance with the rules of the ISP98 as explained in the earlier chapters of the book.

The beneficiary has the responsibility of ensuring that:

1. The documentary presentation under the standby letter of credit includes in addition to the beneficiary's claim, all other stipulated documents in such a way that these documents are fully compliant with the ISP98 and the credit terms. Further, it is necessary to ensure that the default recital

on the Demand is accurate and abides with the standby letter of credit requirements. The beneficiary also needs to check the demand draft to ensure it is properly signed and endorsed where necessary.

2. To denote and explain, on the covering schedule of the presentation (i.e., the covering letter which encloses the documents presented to the bank upon drawing on the standby letter of credit), any discrepancies in the documents presented and to instruct the bank whether or not to seek the applicant's waiver of the discrepancies. (see Rule 5.06 Section 6.6 Chapter 6).
3. The covering schedule includes specific and precise instructions with regards to effecting payment, for example, the account number to be credited with the proceeds and the bank at which this account is held … etc. Furthermore, the schedule must indicate the name of the contact person and his telephone number, fax, email … etc.

In summary, it is the responsibility of the beneficiary to ensure that the presentation is made accurately with full, clear and precise instruction regarding settlements, discrepancies, inquiries … etc.

13.3.8 Beneficiary and applicant

The beneficiary must be careful not to negligently accept any terms in the standby letter of credit that makes payment under the instrument conditional to the presentment of a certificate or document which can only be provided by the applicant itself or any other party outside the control of the beneficiary; this will make the credit inoperable and practically worthless to the beneficiary. In one real life case, a performance standby letter of credit for $35 million securing the default of the applicant to construct a major airport terminal, contained a condition that the beneficiary could only draw on the credit if it presented a document issued by the airport authorities certifying that the work in the terminal was completed successfully. Can you see the danger to the beneficiary?

Today, businesses tend to base their dealings with each other on good will and amicability to ensure the successful completion of their projects and the smooth running of their operations.

A2. Applicant and issuer

13.3.9 Corporate banking – an overview

Banks normally provide credit in the form of overdrafts, loans, bills discounted, or import and export finance. The process of extending any of the

said forms to corporate borrowers passes through two distinctive phases; the credit decision-making process (account relationship management) and the banks' internal operations.

13.3.9.1 The account relationship management

Making a sound decision to extend credit to a corporate customer is a complex process. This is because corporate customers are normally engaged in a wide range of activities and are affected by a host of external and internal factors that have direct impact on their ability to meet financial obligations.

The credit decision-making should, therefore, be directed by an internal lending policy that takes into account such factors and aims to protect the bank's assets, preserve its reputation and optimise the relationship profitability.

In order to allow the account relationship managers to effectively and authoritatively negotiate with their targeted corporate customers, terms acceptable to the bank, an 'Account Relationship Management Acceptance Criteria' or the so called 'Credit Guidelines' should be internally placed and distributed to every credit manager/officer.

These guidelines set the minimum acceptance standards; in simple words, the guidelines are aimed at letting the account relationship managers/officers know exactly what they should be selling, to whom, at what price and under what conditions (securities and other terms). Based on the credit guidelines, the account relationship executive will have to submit a credit proposal evaluating the whole relationship. The Credit Evaluation process must be done systematically and within acceptable standards to maintain a high quality credit portfolio.

The preparation of the credit proposal must be guided by common sense and sensible judgement. The amount of details the proposal should contain naturally depends on several elements, namely the size and strength of the customer, the size of the bank's current and proposed exposure, the socio political environment, the economy, the industry and the bank's position in relation to other creditors.

In conclusion, the bank must have its own system of credit evaluation that is based on assessment of historical, current and projected elements stated hereunder:

a. Financial Analysis; Sales, Profitability, Performance, Funds Flow, working Capital Management, liquidity, balance sheet conditions … etc.

b. Operating Analysis (Operating Risks); Owners, Management, Company, Industry, Markets.

The credit proposal (review) must highlight the Financial Risks and Operating Risks. It should state the magnitude and likelihood of such risks, that is, 'What if' scenarios, and how will they be managed?

Most global banks maintain their credit evaluating standards in an internal 'Instruction Manual' containing the bank's management instructions regarding each and every aspect of the credit extension or review process. It sets the management standard of credit evaluation to eliminate risks and prevent the decline in profit margins on credit facilities.

13.3.9.2 Corporate banking operations

Banks mostly lend against appropriate tangible securities such as deposits, shares, debentures, property, guarantees supported by tangible securities, life policies, goods, gold or other precious metal. Banks may also lend against intangible securities such as unsupported guarantees or assignment of sums due to the borrower by third parties.

It is essential that banks follow the proper procedures in order to obtain good title when taking a security. There is a difference between possession and ownership.

The various forms of documents used for obtaining different types of security are also important. Inadequate documentation may well cause losses to a bank. This is particularly true for the Trade Financing documentation and the Securities Agreement relating to goods.

Banks must also follow proper procedures to realise securities otherwise losses may be incurred.

The corporate operations division are normally responsible for maintaining securities documentation and updating the customers' mandates with fresh account documentation, account statements, financial statements and relationship reviews.

Handling and treatment of delinquent accounts is also an important area of operations. Grading of bad and doubtful debts for an effective recovery process is important. An effective delinquency policy is essential to avoid unnecessary financial losses.

Banks take risks in extending credit facilities to their customers, it is vital that they be able to see such risks as clearly as possible and weigh them up with care and intelligence. One popular method of measuring banks' exposure to risk and expressing this risk in cash terms is the Cash Risk Calculation method.

13.3.10 The issuer's overall relationship with the applicant

Because of the significant risks associated with LC transactions, banks seldom issue LC on behalf of a walk-in customer, moreover, they never issue

LC for individuals; the banks enter into this kind of relationship only with corporate customers and SMEs.

This means a business cannot apply for a letter of credit unless it has a long-standing relationship with the bank; a relationship similar to the ones described in Section 13.3.9 above.

Major banks normally have difficult criterion for setting DCs issuance limits on behalf of their customers, we have previously seen how these limits will have to be part of a whole relationship that could also include other limits such as guarantees, OD limits, import/export loans … etc. The total volume of outstanding credit facilities and outstanding deposits is called the customer's position. The credit facilities are usually secured by adequate mortgages, lien on deposits, guarantees … etc. In some rare cases, a bank may be willing to grant facilities on a clean basis, that is, without any form of security.

From the issuer's perspective, a complete relationship with the applicant that encapsulates adequate and liquid securities is necessary to protect its rights for reimbursement in case of a bankruptcy. In large transactions, however, the securities held with the bank may not always cover the value of the beneficiary's claim paid, like in the case of issuing a standby letter of credit in support of large construction projects. The bank would want to further protect itself and for that it may agree with the beneficiary that payment under the credit will be made with a right of recourse to the beneficiary. This means that the bank can recover from the beneficiary any payment made under the standby letter of credit. This practice was inaugurated in Rule 2.01 (b) (iii) of the ISP98.

In commercial LC, the goods also provide another security for the bank which only delivers the documents of title necessary to clear the goods by applicant once the applicant settles the value of the letter of credit; As long as the transaction is not settled, the bank can either sell the goods or keep hold of them under its custody until the applicant settles. Of course selling the goods by the bank can be done if the bank owns the goods. The bank owns the goods if the transport document is a document of title (Marine/Ocean Bill of Lading) or if it has a court order to do so. In all other cases the bank can not sell the goods. This is the reason why many banks around the world set the commercial LCs import limit only for goods shipped by sea and covered by a marine bill of lading (document of title); they do not issue LCs for goods shipped by other means such as a truck, train, or aeroplane for example.

The circumstances governing commercial standby LC are substantially different of course. This is because of the different nature of the two instruments.

13.3.11 Foreign laws and usages

Rule 1.08 (d) adds to the applicant's burden the responsibility for indemnifying the issuer against all consequences that arise out of foreign laws and usages.

13.3.12 The application form

The application form for a standby letter of credit represents the applicant – issuer relationship with regards to the specific transaction. In addition to the full details of the transaction (i.e., amount, validity, partial drawing, governing rules, type of standby if transferable, full name and address of the beneficiary), the applicant must also stipulate the set of required documents to be presented upon drawing. Applicants normally provide an exact recital (text) for the default situation that must be signed by the beneficiary and presented under its claim to the issuer, confirmer or a nominated person acting on its nomination.

The application form contains the terms and conditions which the issuer agrees to issue the credit under. It may also include several indemnifications from the applicant. The application may be submitted in paper form or electronically using the bank's front-end electronic system with its customers, in which case the e-application will be in a format compatible with the outgoing SWIFT message. To be able to electronically submit an application form or generally use the bank's electronic system, banks require their customers to sign a special separate agreement and a set of documentation agreeing to the bank's terms and conditions and indemnifying it against all problems that may arise from transmitting and receiving messages through the electronic system.

Moreover, the standard terms and conditions in a standby letter of credit application form are:

1. The credit is subject to the ISP98.
2. The undertaking to comply with the relative governmental laws and regulations including those of central banks.
3. The applicant's commitment to reimburse the bank when needed.
4. Indemnify the bank against all claims resulting from accepting fraudulent presentation that appear to be genuine.
5. Commitment to pay the bank's charges even when these are for the beneficiary's account and the beneficiary refuses to pay them.

13.3.13 The necessity to issue a standby LC identical to applicant's instructions

Rule 1.09 of the ISP98 clearly implies that the standby letter of credit must be issued for the account of the applicant who may also be the bank acting on its own behalf or a person applying in its own name but for the account of another person.

The practical significance of the rule is that it subjects the bank to fully compensate the applicant in cases of disputes arising out of an error made by the bank in issuing the letter of credit in terms and conditions that vary from those originally stated by the applicant in the application form. *The bank must be particularly cautious to issue the standby letter of credit in terms identical to those given by the applicant.* For this reason it is vital to observe the following two situations:

1. Where the applicant corrects an instruction on the traditional application form, the *authorized signatory* must sign above or beneath the correction made and the whole form then must be signed by the authorized manager/signatory in the bank. Where the correction is made by the electronic system, the applicant must send a separate message confirming the correction and this message must either be manually signed or electronically confirmed by the bank's authorized signatory/manager as the internal regulations of the bank dictate.
2. Where the issuer issues a standby LC in terms and conditions which do not accurately reflect those of the application form, the beneficiary is able to bind the issuer with these terms and conditions and as such is able to draw on the LC whilst complying with the terms of the received LC and not those of the application form. Here the issuer is liable to honour the presentation and upon claiming reimbursement the applicant may not, and probably will not, agree to reimburse it since it has issued a standby LC with different terms and conditions required by the applicant.

To mitigate the operational risks of electronically issuing a standby LC or an amendment in erroneous terms and conditions, major banks place strict procedures to validate all outgoing messages before releasing them, by different staff of various levels of authority. For example a standby LC for $10k will be validated by a supervisor whilst a standby for $50k will be validated by a supervisor and an A signatory, and so forth.

It is also important not to issue more than one standby LC using the same application form. Every credit is a separate transaction and therefore for each credit there must be a separate application form. Likewise, every credit advice to the beneficiary is separate from the previous advices and for every new credit there has to be a new advice.

13.3.14 Foreign exchange

The applicant frequently requires to arrange for Foreign Currency Payment (FOREX) under the standby letter of credit, and therefore it often liaises with its bank to book forward deals or reserve better rates or arrange for hedging. The department in the bank responsible for the FOREX transactions is

sometimes called the Treasury Department and its functions are closely integrated with the functions of the trade finance department.

13.3.15 Requests for amendments to the credit

The precise requirements for an amendment to become effective were comprehensively discussed in Chapter 3 Sections 3.5, 3.6. 3.7.

The applicant may receive a request from the beneficiary to amend the credit. If the amendment requested is acceptable to the applicant, it will then instruct the issuer to issue said amendment. Occasionally the beneficiary directs the Extend or Pay order/claim to the issuing bank if it seeks an amendment extending the standby credit. (See Section 4.9 Extend or Pay).

Occasionally, the applicant may consult the issuer regarding the recital of the amendment in order to ensure that the amendment may not have any negative impact on the applicant upon issuance.

Amendment must be issued in good time especially in direct pay standby LC requiring payment of interest and or principal of treasury bonds or other securities and the interest rates are changed by the issuer of securities in question.

13.3.16 Request for a waiver of discrepancies

Handling of discrepancies under standby LC was addressed in Sections 6.5 and 6.6.

The issuing bank will frequently receive requests to waive discrepancies by applicants directly from the nominated bank, confirming bank or the beneficiary itself; it must refer these requests momentarily to the applicant and the applicant in turn should respond by advising whether or not it agrees to waive the discrepancies. If the applicant agrees to waive the discrepancies, the issuer must advise the bank from which it receive the request of the applicant's waiver of discrepancies and authorize such bank to pay the value of the standby to the beneficiary and claim reimbursement thereafter.

13.3.17 Checking documents and honouring or rejecting payment

The Issuer, confirmer or a nominated bank acting on its nomination, must examine the presentation and honour it if the documents were presented in compliance with the standby letter of credit terms and conditions and the provisions of the ISP98. Nevertheless, if the presentation was found discrepant, the bank must then act in accordance with the provisions of Rule 5 with special emphasis on giving notice of dishonour with regards

to discrepancies within the time frames set by Rule 5.01 (Section 6.1 Chapter 6).

The applicant has to reimburse the issuer upon honouring a compliant presentation under the standby letter of credit or a presentation with waived discrepancies.

Normally, the process of checking the documents constituting the presentation under standby LC is quite a simple process. This is because under a standby, the documents presented are simple in nature; often a demand and a draft.

13.3.18 Summary

13.3.18.1 Applicant's role and responsibilities under a standby letter of credit

- Ensure that the terms and conditions of its underlying agreement with the beneficiary are complete, precise and fully understood in the same manner by both the applicant and the beneficiary.
- To ensure that the credit is issued in good time especially in cases where a tender bond, performance bond, and direct pay standby LCs are needed within close time frames for submission of tenders or collection of funds.
- To fully understand the application form of the credit so as to complete it in precise and complete terms consistent with the terms of the underlying contract with the beneficiary.
- To respond in good time for the beneficiary's request to amend the credit especially where there is claim for extend or pay.
- To promptly handle requests to waive discrepancies.
- To reimburse the issuer for honouring a complying drawing under the standby letter of credit.

13.3.18.2 Issuer's role and responsibilities under a standby letter of credit

The Issuer's undertaking entails specific liabilities towards not only the beneficiary of the standby LCs, but also the confirming bank and nominated bank acting on its nomination. The responsibilities can be summarized as follows:

1. Issue the credit, strictly abiding with the applicant's instructions and the provisions of the ISP98, in such a manner that enables the beneficiary to

draw on the account by presenting documents that conform to the terms and conditions demanded by the standby letter of credit. This implies that the issuer has a moral obligation to warn the applicant, or even notify the beneficiary, of any terms that could render the credit inoperable.

2. Choose (a) the correspondent bank that will advise the standby letter of credit and, (b) a nominated bank with which the credit will be made available, and (c) a confirming bank if the applicant so requires. Notice that the three functions may be performed by the same bank or more than one bank, there even can be three different advising, nominated and confirming banks.
3. Issue the amendment immediately upon receipt of a complete application to amend from the applicant. Also respond promptly to the beneficiary's request to extend the standby or else pay under it.
4. Act promptly in handling the beneficiary's request to ask the applicant for discrepancies waiver or alternatively to promptly approach the applicant for such waiver without any reference from the beneficiary.
5. Check documents and determine whether or not they qualify as compliant with the demands of the credit.
6. Avoid any intentions or attempts to halt honour of a presentation of documents that appear to comply with the credit demands on grounds beyond the physical presence of the documents, that is, payments must be made against a compliant presentation even though there are objections from the applicant to honour and irrespective of the issuer's ability to reimburse itself from the applicant.

The issuer's other responsibility concerning the specific details of the standby letter of credit issued will be tackled in the next sections of this chapter.

A3. Issuing bank and advising/nominated bank – applicant side

13.4 ISSUING BANK AND ADVISING BANK/NOMINATED BANK

13.4.1 Background

In events where the beneficiary is located in another country, the issuer will necessarily have to use the services of a bank in the beneficiary's country. This could be a branch of the issuer or another correspondent bank. Under

Rule 2.02 of the ISP98, in both cases the banks are considered different banks regardless of whether or not they are branches, that is, a bank with a different function is treated as a different bank, for example, the BNP Paribas in Paris is different from the BNP Paribas in Rome.

The issuer needs a bank to perform either or all of the following functions: (1) advise the credit (function of the advising bank), (2) pay or negotiate the credit as an agent of the issuer (function of the nominated bank that accepted to act upon its nomination), or (3) confirm the credit (function of the confirmer).

13.4.2 The role of the correspondent bank

The correspondent bank is the bank with which the issuer holds an agency arrangement under which both banks agree to provide services within the scope of the agreement, for example remittances, LCs guarantees … etc. and within specific limits set by both banks for each other. The correspondent bank is automatically chosen by the issuer to perform the functions under LCs. Nevertheless, the applicant may choose a bank other than the issuer's correspondent to handle the credit transaction and it may instruct the issuer to make the credit available with, confirmed or even advised by this third bank with which the issuer has no relationship whatsoever. Here the issuer may accept to route the credit through the third bank or it may elect not do so depending on a host of factors amongst which are the credibility of the bank, its financial standing, its reputation, country risks and the volume of the transaction at hand. Hence, it is imperative to have the approval of the issuer to use a bank chosen by the applicant for the purpose of a standby letter of credit.

In global banks like the HSBC or Citibank, for example, the internal regulations of the bank prohibit routing LCs through different banks, and in some countries they even prohibit advising LCs issued by other banks despite the fact that advising an export credit or an incoming standby letter of credit does not impose any liability or responsibility whatsoever on the bank.

It remains to say here that since the issuer is bound to act in accordance with the precise instructions of the applicant, the issuer should notify the applicant, in case it declines to advise the credit or makes it available with the bank of the choice of the applicant.

13.4.2.1 Issuer's responsibility for acts or omissions of the correspondent bank

Rule 1.08 (c) of the ISP98 indemnifies the issuer from any liability for the acts or omissions of a third party including a correspondent bank despite the

fact that such third party/correspondent was chosen or nominated by the issuer itself. It is important that you read Section 2.2.8 in Chapter 2 again.

13.4.2.2 Issuer's responsibility for the costs, charges, fees or expenses of the advising, nominated or confirming bank in connection with the standby LC transaction

Rule 8.02 provides that the party who gives instructions to another party in a standby letter of credit transaction, will be responsible for paying any charges, fees, costs or expenses incurred by the instructed party since these arose in connection with the instructions of the instructor. This literally means that the applicant is responsible for reimbursing any fees, costs, expenses or charges incurred by the issuer in connection with the standby transaction. It also means that the issuer is responsible before any nominated, advising, or confirming person who acts on the instructions received from the same issuer.

13.4.2.3 The extent to which an issuer is indemnified from the responsibility for problems arising from telecommunication

Rule 1.08 (c) provides that the issuer is not liable for the action or omission of others even if the other person is chosen by the issuer or nominated person. This rule in essence disclaims the issuer from responsibility for the underlying transaction, the effect of documents, actions or inactions of others and/or the applications of foreign laws and practice. This soundly implies that the ISP98 disclaims the responsibility for delay, loss, mutilation, and other errors in the transit or transmission of documents electronically or in the traditional paper form, provided the consequences of these risks resulted from the acts of a bank other than the issuer itself. If these risks resulted from the acts of the issuer itself, the ISP98 is silent as to the extent of the issuer's responsibility. You may have noticed the similarity between this rule and Article 35 of the UCP600.

13.4.2.4 Translation

The issuer is not responsible for translating any documents received under a standby letter of credit. Rule 4.04 (Language of Documents) requires that the beneficiary must present documents in the same language as the standby letter of credit. However, Rule 3.13 (b) (ii) (Issuer Waiver and Applicant Consent to Waiver of Presentation Rules) permits the issuer to waive such a requirement.

13.4.2.5 Technical terms

The ISP98 does not explicitly indemnify the issuer from interpreting technical terms related to the standby letter of credit underlying transaction; however, this indemnity of the issuer is implied within, and covered by the situations encapsulated by Rule 1.06 of the ISP98.

In summary, the issuer is protected against the consequences of all material risks which are beyond the control of the issuer. Nevertheless, the issuer is never resolved of its own negligent acts.

13.4.3 The issuer and the advising bank

The issuer arranges to forward the credit to the beneficiary through a bank called the advising bank. The advising bank, as implied by the name, merely advises the credit to the beneficiary without any responsibility on its part. Nevertheless, the advising bank has a moral responsibility to precisely clarify its position to the beneficiary so that the latter does not mistakenly rely on the advice of the former to its detriment, for example, in presenting documents to the advisor just before the credit expires and as such the presentation reaches the issuer after the expiry date. Therefore, the advisor should indicate in credit covering advice/letter it generates that the credit is being advised without any responsibility on its part.

13.4.4 Advising bank's liability

Rule 2.04 (a) and (b) covers the nomination process, and Rule 2.05 advice on issuance and amendment. The most significant responsibility of the advisor is that the advice must signify the accuracy of the data advised, that is, the data in the advice must not conflict with the data of the standby letter of credit.

Rule 2.04 (a) treats the advising bank as a nominated bank whilst Rule 2.04 (b) indicates that an advising bank can only advise the credit once it has agreed to do so. As such, the bank nominated to advise the credit is not obliged to do so; it may select to advise it and it may elect not to do so. The rule emphasizes that the advising bank has a responsibility towards the issuer to notify the latter that it does not accept to advise the credit.

The last responsibility of the advising bank in these two rules is to check the apparent authenticity of the message received from the issuer prior to forwarding it to the beneficiary. By doing so, the bank protects the beneficiary from what could turn out to be a fraudulent transaction.

The ISP does not tackle the problem that may arise if the advisor advises the credit without authenticating the identity of the sender, either because it is not possible to do so or merely because of negligence. The soul of the

ISP98, however, demands banks to exercise best practice and as such the advisor is not encouraged to pass on an unauthenticated advice without at least warning the beneficiary that it is so. Such an action would reflect negatively on the reputation and perception of the advisor.

Normally, banks adopting international standard banking practice would immediately refer to the issuer upon receiving a credit, or an amendment to a previously advised credit, the source of which the advisor is unable to authenticate. Such an action can lead to curing the default by the issuer if it was a genuine credit or to detecting and eventually preventing the transaction if it was a fraudulent one.

The procedures that must be undertaken in advising the credit are the usual examination of the credit operative tool aimed at confirming the identity of the sender, that is:

1. Authenticating the signature of the authorised signatories of the issuer on the standby letter of credit issued in a paper form and sent by airmail to the advisor.
2. When the credit is sent by telecommunication, check the words Message Auth on the top of the SWIFT message if the credit was sent by SWIFT or solve the test key cypher for standby sent by telex.
3. The advisor must also check its black list to ensure that neither the applicant nor the beneficiaries are black listed. Furthermore, it is imperative to check the bank's internal regulations to ascertain whether the bank allows advising credits that involve transactions of the nature/type at hand.

To reiterate, the major role of the advising bank is to deliver the credit to the beneficiary; it normally does so without any responsibility on its part.

13.4.5 The issuer's responsibility to provide the vital details of the credit

1. Rule 2.01 (b) explicitly indicates that the credit must provide for payment either at sight, acceptance, deferred payment, or negotiation. This means that the issuer is responsible for indicating in the credit the method by which the credit is made available.
2. Let us go back again to Rule 2.04 (a). The rule indicates that the issuer may nominate a bank to advise, pay, accept draft or negotiate documents. Hence, the first indicated responsibility of the issuer with regards to providing credit details is to nominate a bank to execute the services required under the standby letter of credit. Failure to nominate a person

to act under the standby means that the issuer on its own, and no one else, is authorized to act under the credit. Alternatively, the credit may be made available with the issuer itself, in which case the issuer's office/branch in the beneficiary's country is treated as another bank.

3. Rule 3.01 dictates another responsibility of the issuer, that is to indicate the time, place, and location within that place for presentation. The rule also demands the issuer to specify the medium in which the presentation should be made.

4. Another responsibility of the issuer with regards to the standby letter of credit details is indicated in Rule 8.04 which demands that the issuer provides a bank acting under the standby letter of credit (confirmer or a nominated person acting upon its nomination whether a Paying bank, an Accepting bank or a negotiating bank), to provide such bank with reimbursement instructions. The rule also provides that such reimbursement instructions are subject to the 'Uniform Rules for Bank-to-Bank Reimbursements' (URR of the ICC-Paris).

5. Additionally, Rule 8.01 (b) (Right to Reimbursement) implies that the issuer is obliged to undertake and perform the responsibilities of the confirmer upon the latter's wrongful dishonour of a complying presentation made by the beneficiary in drawing on the standby confirmation. Naturally, if the credit is to be confirmed, the issuer must also indicate the name of the bank to confirm it, especially if this is a third bank which is different from the nominated advising bank. Sometimes the issuer chooses a confirming bank located in a country other than its own country and that of the beneficiary.

6. Rule 9.01 demands that the issuer stipulates an expiry date after which the presentation of documents will not be allowed. Alternatively, the issuer must make the standby letter of credit terminable by inaugurating a clause to that effect.

7. Rule 9.03 (a) provides that the issuer must commence the time calculation process required for any standby LC related-action on the first business day following the business day when the action could have been undertaken at the place where the action should have taken place. Under this rule, if the credit stipulated a period for expiry instead of an expiry date, the calculation of time for expiry begins to run on the business day following the day of issuance. For instance if the issuing bank states that the credit is to be available for a six-month period, or the like, but does not specify the date from which the time is to run, the date of issuance of the credit will be deemed to be the first day from which such time is to run. Normally banks discourage inclusion of this type of expiry.

13.4.6 The nominated bank's responsibility in standby LCs

The nominated bank must advise both the issuer and the beneficiary of its agreement to act upon the authorisation of the issuer, if of course it agreed to do so.

The second vital responsibility of the nominated bank acting on its nomination is to check the documents in accordance with the standby LC terms and conditions and also in accordance with the ISP98 rules of practice to determine whether or not the presented documents are compliant. Accordingly it is required to honour a complying presentation and claim reimbursement from the issuer or the reimbursing bank as per the credit terms and conditions. Conversely, if the documents presented are discrepant, it must handle them in accordance with the provisions of Rule 5.

A4. Issuer and conformer

13.5 BACKGROUND

The obligations of the issuer and confirmer towards the beneficiary are illustrated in Rule 2.01 (a) and (b) of the ISP98 (See first Chapter 3 Section 3.2). The obligations of both the issuer and confirmer are consistent. They are both bound to honour the irrevocable definite undertaking they made under the standby letter of credit, provided the stipulated documents are presented to the nominated bank or to the issuer and the terms and conditions are complied with. They honour by paying at sight a standby LC available by sight payment, by promising to pay at a future date a standby LC available by deferred payment, by accepting to pay on maturity a demand draft drawn under a standby LC available by acceptance or by paying the amount demanded at sight without recourse for a standby LC available by negotiation.

13.5.1 The responsibility of the issuer

Rule 2.01 (b) indicates how the issuer honours various undertakings. Moreover, Rule 5.03 (b) states that the issuer must give the beneficiary, in addition to the notice of discrepancies/dishonour, a notice of acceptance or acknowledgement that it has taken up the documents and incurred a deferred payment undertaking. If it fails to give such notice indicating that the presentation is a compliant one, it will remain obligated to pay, which means if the bank remains silent regarding its decision to take up the documents, it can not reverse it, if later, a discrepancy was found by another

party to the LC such as the applicant, for example; it will remain responsible for payment on the due date especially as this rule demands of the relative bank to give a notice of acceptance or confirmation assuring that a deferred payment obligation has been accepted and payment shall be made on the maturity date.

Rule 2.01 (c) makes clear the issuer's responsibility to act in a timely manner and clarifies when the issuer honours in a timely manner.

Rule 2.01 (e) further clarifies the issuer's responsibility to honour and explains how the issuer pays.

13.5.2 The responsibilities of the confirmer

Rule 2.01 (d) (i) provides that upon adding its confirmation to a standby letter of credit, the confirmer definitely and irrevocably undertakes, in a second undertaking totally separate and independent of that of the issuer, to honour the beneficiary's presentment of the set of stipulated documents provided that such presentment is compliant to the credit terms and conditions. Hence, the confirmer is responsible for honouring a presentation made in conformity with the credit terms by either paying at sight, undertaking a deferred payment commitment, accept or negotiate. Notice that the confirmer is responsible for honour as if it had issued the standby LC even if the beneficiary presented the documents directly to the issuer.

13.5.2.1 The beneficiary's presentation of documents

Notice that Rule 1.11(c) (i) (Interpretation of these rules) the terms 'issuer' additionally includes the 'confirmer' wherever it is used in the ISP98.

There are two situations that must be noted here; (1) when the text of the standby letter of credit permits the beneficiary to present the documents directly to the confirming bank, and (2) when the text of the confirmation made by the confirming bank allows the beneficiary to present the documents directly to the issuer.

The presentation of the documents to either the issuing or confirming bank within the credit validity period under the circumstances outlined above binds any of them. This means that if the beneficiary first presents documents to the confirming bank which wrongfully dishonours such presentation, the issuer then becomes obliged to honour the compliant drawing regardless of whether it received the documents after the expiry date or not. Conversely, if the issuer erroneously dishonours a complying presentation made to it by the beneficiary, the confirmer then is liable to honour it and thus pay its value as appropriate, that is, either at sight or on a future date.

Nevertheless, if the text of the standby or the confirmation makes it imperative that the documents must first be presented to a specific party, then the presentation must be made as such to be compliant, otherwise it will be rejected. (See Chapter 3 Section 3.1 covering Rule 2.01).

Rule 3.04 (c) provides that if no place for presentation is indicated in the text of confirmation where the standby is confirmed, then the presentation may be made to the place of business of the confirmer (*and in doing so the presentation also binds the issuing bank*), but may also be made to the issuer to bind the confirmer. Hence, it complements Rule 2.01 (d) (Undertaking to Honour by the Issuer and Any Confirmer to Beneficiary). The confirmer here can limit the scope of its confirmation liability by including a clause in its confirmation prohibiting the beneficiary to present documents to any party other than the confirmer and at a specified address. This means that the beneficiary must present the document only to the confirmer to comply with the confirmation clause in order to bind the latter. Nevertheless, the beneficiary in this situation binds the issuer if it presented the documents directly to the issuer, but will not bind the confirmer, that is, the confirmer can dishonour the presentation if it was first made to the issuer and then, after the expiry date to the confirmer.

13.6 ROLES AND RESPONSIBILITIES – BENEFICIARY'S SIDE

13.6.1 Background

The beneficiary is the party to whom the undertakings of the credit in its totality are addressed. These undertaking are encompassed within the following major relationships that form the subject matter of this section:

A. *Advising Bank*: Advises the credit to the beneficiary in accordance with the provisions of Rule 2.04 (a), 2.04 (b) (providing rules for nomination) and 2.05 (regarding advice of issuance and amendments).

B. *Nominated Bank acting upon its nomination*:

   1. In addition to advising the credit, it acts on behalf of the Issuer in examining the documents in accordance with the terms of Rule 4.01 (providing how to measure compliance of documents), Rule 5.01 (setting the maximum time within which the process of checking documents needs to be achieved; the rule provides the principles for measuring which time is reasonable and which is unreasonable in the examination process), Rule 4.03 (stating the documents are not to be examined for inconsistency unless the standby so stipulates), Rule 4.02 (providing

that extraneous documents must be disregarded and may either be returned to the presenter or passed on without any responsibility) and Rule 4.11 (providing that non-documentary conditions are to be disregarded and defining the term non-documentary conditions).

2. Determines on the basis of the documents alone whether or not they appear on their face to be in compliance with the credit terms and conditions. If the documents were found discrepant, the bank must treat them in accordance with 4.01 (providing how compliance of documents is to be measured and how can it be determined), Rule 1.06 (c) and (d) (illustrating the independent documentary and binding character of the ISP98), Rule 5.05 (clarifying the issuer's discretion to ask for the applicant's waiver of discrepancies), Rule 5.01 (b) (setting the method by which notice of refusal of documents is to be calculated, and how the promptness of the notice is to be determined), Rule 5.02 (requiring that a notice of dishonour must state all discrepancies that led to the rejection of documents), Rule 5.07 (providing that dishonoured documents must be returned to the presenter, held at the bank's counters or disposed of as reasonably instructed by the presenter. The rule also clarify that the bank need not give a notice of disposition of documents in the notice of dishonour), Rule 8.03 (providing that the nominated person is obliged to refund with interest, any reimbursement amount is the issuer timely dishonours) and Rule 5.06 (recognising the discretion of the bank to whom the discrepant presentation is made to accept or reject a request to forward the presentation and providing rules in the event it chooses to exercise discretion).

C. *Confirming Bank/Confirmer*: Issues its own undertaking separate and independent of that of the issuer, to honour a presentation of documents made under the standby letter of credit in compliance with the terms and conditions of the LC and the provisions of the governing rules; usually the ISP98. The precise responsibilities of the confirmer were tackled in details under Section 13.5.1 above.

D. *Issuing Bank*: Issues the standby letter of credit on behalf of the applicant and accordingly undertakes to the beneficiary to honour the value of the presentation the latter makes provided it complies with the credit terms and condition and the provisions of the ISP98.

13.6.2 Beneficiary and advising bank

The advising bank advises the credit to the beneficiary in accordance with the provisions of Rule 2.04 (a), 2.04 (b) (providing the basis of nomination) and 2.05 (on the advice of issuance and amendment).

The advising bank is the party that delivers the credit instrument to the beneficiary. However, it does so without any responsibility on its part; it merely passes on the credit to the beneficiary and dispatches the documents received from the beneficiary to the issuer if the beneficiary so requests. As such, the advisor makes it clear to the beneficiary in its cover advice enclosing the credit instrument that the scope of its services is limited to handing over to the beneficiary the standby letter of credit instrument.

The beneficiary may also forward to the issuer any requests from the beneficiary to amend the credit so that the issuer in turn passes these on to the applicant. Normally the beneficiary directly contacts the applicant with regards to amending the credit. Occasionally, however, it may send the written request through the banks.

The major responsibility of the advisor is stated in Rule 2.05 (a) which is to issue an advice that precisely and accurately reflects the original credit received from the issuer, or else the advisor will be held liable for any subsequent losses that may arise as a result of any deviations between the data on the advisor's advice and the original credit instrument.

13.6.3 Beneficiary and nominated bank/confirming bank

A nominated bank acting upon its nomination may either be called the Paying bank, the Accepting bank or the Negotiating bank depending on the function it will undertake which, in turn, depends on the type of availability of the standby itself. The bank will be called a confirming bank if it adds its confirmation to the credit. Whatever the responsibilities of the nominated/confirming bank are, they must be clearly conveyed to the beneficiary in the covering advice enclosing the original standby letter of credit.

The bank would be wise not to discuss with the beneficiary any discrepancies in the documents before the formal presentation is made by beneficiary. This is to avoid the risk of repetition of the same discrepancies or similar ones in the formal presentation of documents at which time the beneficiary may blame the bank on the grounds that they led the presenter to believe that the discrepancies were cured and henceforth the bank to take up the discrepant documents. The risks depicted by such circumstances were illustrated by the case of Floating Duck Ltd. v. The Hong Kong and Shanghai Banking Corporation.

From a practical banking opinion, it would also be very wise for the nominated or confirming bank to record their discussions with the beneficiary on a special form to be kept on file in case it is needed in the future.

The Nominated bank's responsibilities towards the beneficiary:

1. Advise the credit.
2. Check the documents received from the beneficiary according to the provisions of Rule 4.01 (Determining Compliance), Rule 4.03 (examination for inconsistencies), 4.11 (Non-documentary terms and conditions), and 5.01 (Timely Notice of Dishonour).
3. Process discrepant documents in accordance with the provisions of Rule 8.01 (providing for the issuer's and applicant's reimbursement obligation and indicating the matters for which the applicant is responsible to indemnify the issuer, and indicating the scope of the reimbursement provisions of the ISP98), Rule 4.01 (Providing the methods to follow in determining compliance and setting the standard of compliance for documents), Rule 1.06 (c) and (d) (stressing the independent, documentary and binding character of the standby letter of credit subject to the ISP98), Rule 5.05 (indicating the right of the issuer to exercise its own discretion to seek the applicant's waiver of discrepancies), Rule 5.01 (b) (indicating how to calculate the time for giving a notice of refusal for discrepant documents), Rule 5.02 (providing that a notice must state all the discrepancies that led to dishonouring the presentation) and Rule 5.07 (pardoning the inclusion for giving a notice of disposition of documents) and Rule 8.03 (providing that the nominated person is obliged to refund with interest, any reimbursement amount is the issuer timely dishonours) and Rule 5.06 (acknowledging the discretion of the bank to whom the discrepant presentation is made to accept or reject a request to forward the presentation and providing rules in the event it chooses to exercise discretion) and Rule 5.03 (regulating that failure to give notice of discrepancy in a notice of dishonour within the time and by the means allocated in the standby and the provisions of the ISP98 precludes the bank from claiming that the documents are discrepant and precluding late assertions of discrepancies not noted in the first notice of dishonour including raising such discrepancies in another representations).
4. Advise the beneficiary of the results of the documents' examination and within the time limits set in the rules discussed in points 2 and 3 above.
5. Await the beneficiary's regulations with regards to the discrepant presentation. The bank may also choose to contact the applicant directly acting on its own discretion as per Rule 5.05.

13.6.4 Beneficiary and transferring bank

The requirements to issue a transferable standby letter of credit subject to the provisions of the ISP98 have been tackled in details in Chapter 7. In

this section we shall address the specific aspects of the transferable standby letter of credit transaction correlating the transferring bank and the beneficiary.

The transferring bank can only transfer a credit if it is specifically designated as transferable. Once it agrees to transfer the credit, it may want to obtain the following:

1. The beneficiary's request in a form acceptable to the issuer or nominated person including the effective date of the transfer and the name and address of the transferee; the original standby, verification of the beneficiary's authorised signatory and its designated authority; an undertaking to pay due fees; and any other reasonable requirements.
2. Upon affecting the transfer, the transferor must obtain the beneficiary's demand or draft duly signed by the latter. In addition, the beneficiary's agreement that its name may be used in place of the name of the transferor beneficiary in any other required document.
3. Affect the transfer in its entirety. The credit may subsequently be transferred again for third and fourth beneficiaries as the case may be. Nevertheless, the credit may not be transferred in part, this is prohibited by Rule 6.02 (b) (ii).
4. The transferring bank owes a duty of confidentiality with regards to the dealing of the first beneficiary with the second and subsequent beneficiaries.

13.6.5 Beneficiary and issuer

Upon issuing the credit, the issuer undertakes to the beneficiary to pay against complying presentation. Regardless of the existence of a nominated bank that agreed to act on its nomination or a confirming bank, the beneficiary is always entitled to present the documents to the issuer who is ultimately responsible for honouring their value provided they are compliant. This is the theme of Rule 1.06 (d) (Nature of Standbys).

Rule 2.01 (b) set the nature of the issuer's undertaking to honour a complying presentation and its implications where the undertaking is to pay at sight, to make a deferred payment undertaking, to accept or to negotiate. Furthermore, Rule 5.03 (b) indicates the liabilities of the issuer pertained to a failure to give a notice of acceptance or incurring a deferred payment undertaking obligates the issuer to pay at maturity. This is true even if the documents were found to be discrepant at a later stage.

Rule 2.01 (c) explains when the issuer honours a beneficiary's presentation in good time, whilst Rule 2.01 (e) illustrates how an issuer pays the beneficiary.

Rule 2.01 (a) sets the issuer's obligation for the beneficiary to honour.

13.6.6 Interdependence of obligations – honour/dishonour situations

i **Conforming documents** Upon presenting documents to either a nominated bank acting upon its nomination or a confirming bank, the latter will check documents to determine compliance. If documents are found to be compliant the bank will pay the beneficiary the value represented by the documents and claim reimbursement from the issuer who usually pays through a third bank called the reimbursing bank. The issuer in turn receives reimbursement from the applicant.

In cases where there are two distinct banks involved in the transaction; a nominated bank and a confirming bank, the nominated bank pays the beneficiary and receives reimbursement from the confirming bank who, after settling with the nominated bank, in turn receives reimbursement from the issuer. The issuer then covers itself by debiting the applicant's account.

ii **Non-conforming documents** Where the documents presented by the beneficiary to the nominated bank are discrepant, the nominated bank returns the documents to the beneficiary without any responsibility on its part.

iii **Documents conforming at one point and discrepant at the other**

A. **The relation between the nominated bank and the confirmer regarding presentation** The nominated bank acting upon its nomination receives the compliant documents from the beneficiary and honours its value by either paying or undertaking to pay at a later date. The nominated bank then claims reimbursement from the confirming bank which pays the former and claims reimbursement from the issuer who in turn pays and finally claims reimbursement from the applicant.

The problem arises if the confirmer upon receiving and checking the documents finds discrepancies which the nominated bank negligently and wrongfully failed to spot upon checking the documents when they were first presented by the beneficiary. Here, the confirmer will request the nominated bank to refund with due interest, the value previously received under the same transaction (Rule 8.03

applies equally to both the Issuer and Confirmer). The nominated bank will refund to the confirmer, the amount received in reimbursement. The nominated bank then will try to recover from the beneficiary the amount wrongfully paid to it and would probably be able to do so if the payment agreement with the beneficiary is based on a *recourse* term. If, however, payment was made *without recourse*, the nominated person will not be able to recover payment.

In cases where the standby LC is available by negotiation, payment is made without recourse and as such the nominated bank will not be able to recover from the beneficiary the wrongful amount paid (Rule 2.01 (b) (iii)), unless of course the text of the standby letter of credit stipulates otherwise, that is, explicitly alters or totally excludes the provisions of the Rule 2.01 (b) (iii) mentioned earlier.

B. **The relation between the confirmer and the issuer regarding presentation** If the confirmer decided, upon checking the documents received directly from the beneficiary or from the nominated bank, that the documents are complaint and as such it reimbursed the nominated bank, it will claim reimbursement from the issuer who will honour the confirmer reimbursement claim either directly or through a reimbursing bank. If upon receiving the documents, however, the issuer spotted discrepancies which went negligently unnoticed by the confirmer, the issuer will call on the confirmer and recover with due interest, the amounts previously paid under the confirmer's wrongful reimbursement claim, once again the provisions of Rule 8.03 apply and the confirmer is bound to repay.

Naturally, the confirmer will call on the nominated person or the beneficiary as the case may be, in order to recover the amount it wrongfully paid. Here too recovery is dependent on whether payment by the confirmer was made with or without recourse. If the confirmation text of the confirmer to the beneficiary was based on a *recourse* term, the funds paid will be successfully recovered. Conversely, if the text of the confirmation addressed to the beneficiary included a *without recourse clause*, the confirmer will not be able to recover the funds wrongfully made under the standby letter of credit.

In cases where the standby letter of credit is available by negotiation, payment is made without recourse and as such the confirming bank will not be able to recover from the beneficiary the wrongful amount paid (Rule 2.01 (d) (i)), unless the standby letter of credit stipulates otherwise, that is, explicitly alters or totally excludes the provisions of the Rule 2.01 (b) (iii) mentioned earlier.

C. **The relation between the confirmer and the issuer regarding presentation** In cases where the issuer decides that the documents

received are compliant and honours its value before dispatching the presentation to the applicant. The applicant will refrain from reimbursing the issuer if it discovered that the presentation is discrepant. The issuer may not be able to recover from the confirming bank depending on the terms of its agreement with the latter. Nevertheless, if the agreement was with recourse, then the issuer will recover from the confirmer. The confirmer will in turn seek recovery from the beneficiary or the nominated person acting upon its nomination; its ability to recover the amount paid is dependent on the terms of the confirmation it made.

It is vital to remember that in cases where the standby letter of credit is available by a method other than payment at sight, the relative bank will not be able to reverse its undertaking to pay on due date if the relative agreement is based on a 'without recourse' term. In contras, the relative bank will be able to cancel its undertaking to pay on a future date if the payment was made on a 'recourse' basis. This is true for all other situations depicted under points A, B, and C above.

13.7 ROLES AND RESPONSIBILITIES IN BANK-TO-BANK REIMBURSEMENT

13.7.1 Background

Rule 8.04 of the ISP98 regulates that instruction to obtain reimbursement from another bank is automatically subject to the ICC – *URR525* or the so called The Uniform Rules for Bank-to-Bank Reimbursement – ICC Publication number 525. The URR are very significant in international trade and business transactions. It is the pillar that enables banks to safely reimburse themselves under transactions subjected to them and thus enabling the whole system of payment in global banking.

13.7.2 Definitions

Article 2 of the URR525 defines the following terms:

Issuing Bank: Shall mean the bank that issued a credit and the reimbursement authorization under that credit.

Reimbursing Bank: Shall mean the bank instructed and/or authorized to provide reimbursement pursuant to a reimbursement authorization issued by the issuing bank.

Claiming Bank: Shall mean a bank that pays, incurs a deferred payment,

accepts draft(s), or negotiates under a credit and presents a reimbursement claim to the reimbursing bank. 'Claiming Bank' shall include a bank authorized to present a reimbursement claim to the reimbursing on behalf of the bank that pays, incurs a deferred undertaking, accepts draft(s) or negotiates.

The reimbursing bank merely acts on the instructions received from the issuer with regards to reimbursement under the standby letter of credit. The reimbursing claim needs to be precisely reflective of the reimbursement authorization held with the reimbursing bank. Any deviation will either cause delays or non-payment. The claiming bank needs to refer to the issuer to resolve problems related to the reimbursement claim as the reimbursing bank is merely a representative or an agent of the issuer and its responsibility is confined to executing the reimbursement claim per the instructions of the issuer.

13.8 RELEVANT DISCUSSION

13.8.1 The integrated functions of the trade finance and treasury departments

The functions of the treasury department in commercial banks are deeply integrated with the trade finance department operations. To successfully pursue the bank's profitability and growth objectives, dealers in treasury, in addition to credit executives/officers, are required to comprehend how to manage the financial activities of trade finance transactions effectively, securely and profitably. This is especially important for the following financial activities.

The financing (funding) mechanisms allowed by the bank and the circumstances that provoke their use.

The means by which trade services providers should be selected or the criteria that should be applied to evaluate such providers.

The provision, in a momentarily manner, of information on outstanding and forthcoming financial transactions (standby LCs, commercial LCs, Guarantees and Collections) so that dealers and account relationship managers can extract the highest possible value from cash management.

Although the responsibility of financing international trade and financial transactions falls on the corporate credit executives, the treasury dealers are the source of cash and they are ultimately responsible for procuring it for all payments and dispensing of it or internally distributing it upon receipt. For this reason, the treasury managers are bound to understand the financial activities pertained to funding trade.

Trade Finance Departments' transactions are classified into three types; import, export and standby (guarantees for default situations). For the import LC, the bank is obliged to pay the value of the compliant documents to the beneficiary either directly or indirectly as the case may be. Different banks have different procedures in effecting payment for beneficiaries, some banks call the treasury immediately upon determining that the documents conform to the terms and conditions of the LC and the treasury in turn procures the amount in the bank's journal accounts whilst the LC department debits the applicant's account with the value of the documents plus charges if any.

Conversely, in all export transactions whether under an LC or IBC (export/inward bills for collections), the reimbursement amount must eventually be collected whether the amount is credited directly into the beneficiary's/exporter's account before or after the funds are received from the issuing bank. Are the funds an unexpected surprise? Are plans in place for their use? These questions simply reflect the responsibilities and involvement of the treasury manager whether or not she is explicitly involved in trade.

For standby LC guaranteeing performance or covering a default situation, the bank would be required to cover the value of the claims drawn by beneficiaries within a reasonable period. Due to the relatively large volumes and numbers of standby LC, it becomes essential to manage cash available for those settlements in an effective manner.

In some banks, the Trade Services Department only report the disbursement transaction to the treasury if the value of the documents exceeds a certain amount, say $75,000 for example.

Importing Dangers: For example receiving a Coca Cola shipment in Moscow in December.

An LC is a financial commercial tool issued by the importer's bank as a means of assurance of payment for the exporter/beneficiary – when all the terms and conditions of the LC are met – in return for the exporter's goods or services delivered within a specified period. The import LC equally constitutes a means of assurance for the importer as well since it protects the buyer by authorizing payment only when all required documents are presented and stipulations regarding production materials, delivery dates, storage of finished products, manufacturing processes, quality levels, and prices have been fulfilled. LCs keep a company's capital liquid before the goods are delivered. The following fictional example gives an idea of how the commercial letter of credit works in practice.

Supposing a Lebanese sports wear company named 'Beirut Sports' contracts with 'Nike Tennis Clothing Company' in San Diego CA for 15,000 pairs of tennis shoes, – 3000 each of sizes five, six, seven, eight, and nine – all white with blue stripes. An extensive amount of detail is indicated. This detail is designed to protect the buyer from fraud or omissions (arranging for inferior, erroneous, or non-existent shipments). There is no room for mistakes here.

Similarly, if the goods description in a credit reads 'Three Meter Long Iron Bars' and the commercial invoice shows goods description as 'Iron Bars', the supplier will not be paid because certain conditions have not been met; a shipment of one metre-long Iron Bars is useless for the contractor who needs to complete the roof of a concrete building and on whose behalf the LC was opened. Insurance amounts, packaging, and delivery dates are also specified in the document (since, for example, a supermarket in Moscow might not like to receive a shipment of Coca Cola in December).

13.8.1.1 Extensive details

Because the electronic international trade failed to take-off, international trade continues to be a document-driven business, with lots of details to be agreed upon by both the importer and exporter. When an agreement is reached, a purchase order is drawn up and mailed, telefaxed, or telexed to the seller. The importer – Beirut Sports – then arranges to issue a letter of credit by its bank containing terms and conditions precisely reflecting all the information outlined in the sales contract. The credit is then advised to the exporter through the issuing bank's branch, a correspondent, or by a third bank designated by the exporter. With the payment assurance provided by the LC, the exporter arranges for the shipment of the goods or provision of the services and issues/collates the documents stipulated in the credit, whilst ensuring that these documents are fully compliant with the credit terms and conditions; afterwards the exporter presents the documents to the concerned bank and receives payment.

Upon receiving the LC, the exporter may take the LC to a local bank and request an advance on payment.

Although rare in the Middle East, in the Far East, Europe and North America, LCs are frequently used to obtain financing. In some instances, the goods will already be part of the seller's inventory so, the order can be filled immediately. In this example, the exporter in the United States of America will produce the shoes. The next step for the exporter is shipping the cargo and obtaining the stipulated shipping documents. It is useful to read the Articles 19, 20, 21, 22, 23, 24 and 25 in the UCP600 to get acquainted with the various transport documents used in international trade.

The negotiating bank examines the documents to ensure that they are free from discrepancies; it is usually the minutiae that cause problems. Wording must be precise and all typographical errors have to be corrected. If any of the terms or conditions specified in the LC cannot be met, then the importer, the issuing bank, and the advising/negotiating bank must waive the discrepancies, resolve them with the exporter or reject the documents within the time limits and other requirements provided for in Articles 14 and 16 of the UCP600.

The packaging for the tennis shoes should be indicated in the credit; normally it is a box of a certain size. The exporter may intentionally substitute other sizes for the sizes originally ordered. These changes constitute discrepancies that must be handled in accordance with the provisions of Article 16 of the UCP600. Otherwise the seller runs the risk of not being paid because the bank is not obliged to honour a draft or documents if it is not or they are not conforming. Examples of typical discrepancies include:

- invoice shows an amount which differs from the amount on draft,
- bill of lading date is later than the shipping date specified in the LC,
- invoice doesn't indicate the stipulated Incoterm (International Commercial Terms) (FOB (Free on Board), DAF (Delivered at Frontier), FCA (Free Carrier), DDP (Delivered Duty Paid), CFR (Cost and Freight) … etc.)

When the shipper clears the documentation, it is delivered by the exporter to his bank or the advising bank if different – in this instance, an American bank – which should scrutinize it and honour it if it was a nominated bank acting within its nomination or a confirming bank, but often banks in the United States of America act as merely advising banks when handling LCs issued by banks in the Middle East and forward the documents without any responsibility to the issuing bank for payment. All documents are closely examined. The bank's responsibility is to ensure that all documents are conforming to the letter of credit stipulations. Finally, payment is authorized; the importer's account is debited and 15,000 tennis shoes are released.

The above represents a description of how the import LC is supposed to work – and long history proved that it does when everything goes as planned. However, mistakes and omissions can occur and with daily work pressure significant details can slip through unnoticed.

13.8.2 Selecting the right bank to handle your letters of credit

The LC is a core service in banking. However, the quality of an LC varies considerably from bank to bank. Documents can clear within 24 hours or could take up to a whole five days. Issuance can be done almost instantaneously by the bank's automated system or it may need to go through a slow manual process. What are the elements that an applicant must consider in the process of the selecting the bank that will issue its LCs? What should it look for, and how will it know when the right blend of technical knowledge and practical experience has been found?

A good bank is a source of contacts for the company, a repository of relationships that can be of assistance in a particular country whether with funding or distribution. A bank should be helpful in providing introductions so that the business can be conducted smoothly and easily. A large correspondent network is essential.

It is interesting to know that a recent statistical bulletin released by the Federal Reserve Bank revealed that only 25 US banks handle more than 90 per cent of the dollar flow related to international transactions. These players will obviously have a larger network of branches and correspondents and thus a more extensive reach. It is prudent that the banker has intimate knowledge of the local customs and regulations so that the appropriate level of expertise can be employed to overcome anticipated and unanticipated problems.

The bank's commitment to the country in which the transaction counterparty is resident should be examined. Questions such as 'for how long has this bank been operational in the country?' need to be asked. Further, questions like the ratio of local nationals hired to expatriates need to be examined: A large base of local hires connotes local expertise and can provide a telling indication of commitment. What is the bank's reputation among the people with whom the company is doing or wants to do business? At the same time, companies should consider the bank's commitment to providing international trade services.

Many banks are rethinking, revising and even restructuring their trade finance strategies. They are mainly aiming at reallocating their scarce resources to areas which have proven to be the source of their highest profits; they are converting to niche strategies rather than randomly serving the mass populations of a country or a region. Major banks around the globe have invested heavily to establish and maintain a large network of contacts needed to perform effectively in carrying our their customers' international transactions.

Commitment to service is tantamount to integrity in importance. It is vital to be certain of the bank's commitment prior to entering into any contractual relationship with it, but how can it be assessed? Ask direct questions. Bankers are normally quite expansive and ready to address any concerns about their bank and the resources they dedicate to allow their clients to avail themselves of. It should generally investigate the bank's client base; is it extensive and is it profitable? Does the bank make money on trade finance in this region and does it offer standby LC in addition to commercial LC constantly? If it does not, how fast can it act? Of course one must probe beneath the surface to find the unvarnished truth.

In choosing an LC issuer, the company also needs to ascertain the compatibility of the bank's internal operations and automated system; this is a complex technical terrain that requires vast experience and precise practical

knowledge since operational mistakes could be quite devastating. Hence, it is vital to explore a bank's processing capabilities in addition to the level of experience employed especially with regards to LC involving huge amounts such as standby LCs for major construction projects and commercial LCs for oil transactions. The credit aspects of the relationship with the bank need to be examined as well. This is the part concerning the issuance line, advising line, credit limits and others.

Despite the fact that many functions are fully automated at certain banks, there is still a considerable level of manual work involved in handling presentations and perusing documents. As discussed earlier, the paper generated by the typical LC transaction is voluminous. The ability of organizing and controlling the flow of paperwork will affect the management of the corporation's cash flow. A company needs to ascertain the time taken by a bank to process a transaction. The treasury manager may well visit the trade finance centre where all the operations are conducted to observe how LCs are issued and advised, and what reports are generated and how precise and comprehensive data can be provided.

If the company needs a customized reporting for example, where reports are required to be drawn up in a particular manner; by invoice, purchase order number, or internal identification codes … etc., the company should check how the bank would address this request. Is the bank capable of accommodating such operational requirements?

Finally, a company needs to assess the efficiency of the trade finance area within the bank. Is it a centralized division with marketing, product management, customer support, and operations all unified under one same head, or are the different components scattered throughout the branches and head office? And how closely is it aligned with the credit division, the treasury department, the front office … etc.?

13.8.3 Choosing a bank: from an exporter's/seller's/contractor's perspective

In export transactions, whether for standby LC or commercial LC, risks are much more difficult to assess for a multitude of reasons; (a) the ambiguity of the external regulations and legal issues an importer is subject to, (b) the difficulty to obtain reliable credit information on foreign firms, (c) the complexity of evaluating the risk of the exporting country where issues such as the balance of payments, foreign exchange control, political and social stability have to be carefully looked at. Hence, companies would naturally want to shift the onus of examining how secure their transaction is to a bank who is capable of doing so and sometimes regardless of a reasonable rise in costs.

When a company is engaged in exporting products or services, an activity that has increased considerably amongst the globe's countries, the bank

assumes a significant role. This is especially true when the bank is a confirming one. Again, this is an illustration of the complex risks such as political risks, economic risks, foreign exchange risks, social risks … etc. which are inherent in LCs transactions.

A confirming bank always examines the credit risk of the issuer which may well be unknown to the exporter. The confirmer's main role is to protect the exporter from the wrongful dishonour of the importer or the issuer as the case may be or if payment is halted for any other reason (for example political crisis, the new FOREX controls, new regulations, etc.). In essence, the duties of the confirming bank are a mirror image of those of the issuer.

The risk is dwarfed to its minimal level when the seller/exporter/contractor exports to a stable socio political environment, with a reputable or known trading partner, whilst the credit has been issued by a reputable indigenous bank. Here the confirmation would most probably be superfluous.

Conversely, confirmation of an LC is a common practice in regions where the socio political and economic environment is volatile. This is particularly the case when the issuer is not an indigenous bank with a good reputation.

The main point the exporter/seller/contractor demands of the confirming bank is a strong financial position. This is because the confirming bank is the ultimate party to honour if payment is not obtained in the normal course of the transaction. The issues to be examined here are:

- The capitalization of the bank.
- Evaluation of the adequacy of the bank's financial position against its financial obligation under the letter of credit and in accordance of the current regulations and legal requirements.
- The reserves and allowances held by the bank for trade finance emergencies.
- The bank's delinquency ratio.
- The bank's shares, and trends of their price fluctuation for the past year.

13.8.4 Emergency situations

Knowledge of the specificities of the local markets is vital in order to ensure conducting faultless operations and preventing potential operational errors. For example issues such as the language barrier, the efficiency of the legal system, the general standard of professional practice amongst local banks … etc.

The exporter's relationship with its bank should be of an advisory character. This means that the banker has a moral duty to technically advise and

warn its customer of the risks pertaining to the transaction at hand, including explaining to the customer how operational efficiencies can be achieved by precisely adopting various procedures. From a marketing stand, the bank would be wise to assume a partner's role with its client rather than a service provider.

The consequences of issuing an LC in isolation of the market's requirements can be quite devastating. An example that best illustrates this is the case of a construction company that requested its bank to issue a letter of credit to import raw material from Bolivia by rail. The shipment was lost on the way between the railway stations in Bolivia and Argentina because of the wrongful way in which the credit was worded. The issuer, not aware that the specific area in which the goods were to be transshipped was full of bandits, stipulated in the credit that the goods were be transshipped on the borders of Argentina from the railway on which it is carried onto a truck. There it was abducted by gangsters after it was loaded on the truck. The documents presented were compliant and the issuer honoured the presentation. Nevertheless the goods never arrived and the applicant was unable to recover losses as the credit was issued without recourse. Had the bank that issued the credit worded it differently whilst taking into consideration the risks in light of the environmental specificities of that area, it could have prevented the loss. Its weak knowledge of the market and lack of experience were the main causes of the problem.

A bank that is experienced with the Latin American markets would have advised the exporter not to transship the goods or to use a more secure mode of transportation.

A fairly old poll in the United States of America indicated that more than 75 per cent of all LCs documents are rejected upon first presentation because of discrepant documents. Half of these are corrected and resubmitted for approval. Others are either kept pending approval of the applicant to waive discrepancies or returned to the issuer for further action. It is said that this was the main reason behind revising the UCP500 into the UCP600.

13.8.5 Reiteration

To reiterate, it is vital to use a bank with a large network that enables the customer to complete its transaction safely albeit in the local market environmental vagueness tackled above.

For the exporters, the primary objective is getting paid. Their concerns emerge from the transaction's risks; delivery of the goods, late arrival, proper processing of documents in accordance with the governing rules, that is, UCP, ISP, URR … etc.

In large transactions, the process of settlement and reimbursement thereafter can be very costly if the bank handling the transaction is inefficient.

A one-night delay in crediting the account of the customer with a transaction above $1Mio could cost up to $10k. The real cost (opportunity cost of such delay) could be much higher especially for that treasury manager who is responsible for utilizing the funds in profitable use. Hence, the compatibility of the bank in processing international receivables is an important element for the company to consider in choosing the bank to deal with. The same criterion applies equally in choosing a confirming bank.

In cases of late settlements, for instance, the account of excess balances should be swept to avoid placing cash idle. While the sweep is not considered a primary investment vehicle, it is very useful where an account is suddenly flush and when the treasury has not been notified to act in good time so that it make use of the windfall. Crediting an account is not the most ideal measurement a professional banker should take, rather it must follow prudent cash management steps to ensure that the funds are put to best possible and profitable use.

Of course it is the beneficiary who should be concerned as to how to collect its funds and what the best use is for them. Nevertheless, it is prudent banking practice to provide an effective support and good advice to its customers in order to strengthen its relationship; as discussed earlier on, a bank must act as an advisor rather than a mere service provider. Another useful role the bank can assume is that of information provider for the cash manager of the company. Details such as future credit dates, value dates exchange rates are inevitably vital for the cash manager in efficiently directing the funds to their best use.

The operational obstacles that a treasury manager faces in a company are mainly related to the provision of information related to the financial side (settlement) of the transaction. Treasury managers frequently claim that the information they want is always available in the company, but the company's large size, complex operational procedures, and remote locations of staff are the obstacles that prevent them from obtaining the information they need. This is why the treasury managers in corporates demand that this reporting function should be performed by their bankers upon validating the entries to credit the company's account.

This is a possible process. Once it is a common practice, cash managers will no longer cry with anguish. At last they understand what that line marked $7,778,497.62 is without having to go through the agony of searching in frustration the files and piles of papers.

Additionally, assigning the responsibility to the bank for notifying the treasury manager of all credit transactions, will also enable them to understand the full operational process of handling the LC. In fact, there is nearly always a lag between the time the confirmer receives the documents and peruses them and the time the money is actually available for settlement.

It does take two or three days to debit the account of a correspondent bank in settlement of a credit transaction. Some banks require a notice of up to one calendar week prior to the due date for settlement. Some delays occur because of time differences whilst others may be the result of internal rules and regulations that could prevent prompt turnaround.

Frequently, the treasurers at a company may not be familiar with these sources of delay and may actually arrange for disposing of the funds on certain days only to discover the delay later on. It is imperative to avoid such situations, which may have a negative repercussion on the relationship, to inform the treasury manager of these sources of delay and the practices and customs of the country with which the transaction is to take place well in advance before the value date of the transaction.

In general, banks providing LC services to a customer should resume a consulting role and continuously seek to analyze the operational needs of their clients. They should regularly investigate the client's performance and their growth objectives; the new potentially profitable market segments that should be penetrated; the efficiency of the automated system. This sort of analysis, should only be a general one and based on the market knowledge of the bank. It merely aims to strengthen the bank-customer relationship and raise loyalty. Conversely, banks should not over-indulge themselves in turning into local managers for their customers.

13.8.6 The effect of global change

Nowadays, countries around the globe are becoming closer and closer. Cultural, spiritual, religious and social barriers are melting away between the various nations of mother earth. People everywhere are calling for peace and harmony. Nevertheless, the risk factor continues to highlight the need for LC in commercial transactions.

On international scale, transactions are may reach up to $100mio as in the case of major construction projects and oil LCs. It is solidly established that the role of the treasury department is significant in handling such transactions. The role of the bank as an advisory reference supplements the functions of the treasury manager, with their vast technical knowledge and globally scarce expertise in the trade finance terrain. In addition, the need for financial details pertaining to the settlement of the transaction emphasizes the role of the bank as an advising partner as well as a service provider.

To summarise, the company should seek dealing with a bank of adequate financial standing, fully committed to service and technically efficient with a large network of branches and correspondents.

CHAPTER 14

Risk Management

14.1 INTRODUCTION

The trade finance department is by far the most important division in banking. The LC department is the heart of any commercial bank, not only does it generate vast funds and non funds income (Interest free income), it also replenishes the personal bank with deposits, personal loans, credit cards, auto pay and so on.

The commercial and service businesses in general, who normally are the perfect targets for the private banking departments, mainly care about the standards of trade finance services. It is the bank which masters the trade finance services and is the one that always wins the largest market share. For this reason, global banks have made their trade finance departments their utmost priority. Today credit executives have seized to sell credit (Loans and Over Drafts (ODs)), in fact loans and ODs are merely used as inducements to attract new relationships with merchants who utilize trade finance products.

Unlike any other banking products, the LC is deemed to be one unit. The simplest of discrepancies can lead to the loss of the total value of the LC.

Standby LC operations are mighty complex, and so intricate to the extent that all banks exert rigorous efforts to create an operational environment conducive to achieving optimum efficiency, full control and exemplary customer service. Adopting the international standard banking practice as instituted by the ICC is a prerequisite to initiating competitive service that will enable local and regional banks to compete against banks such as the JP Morgan, HSBC, CitiBank, Sumitomo Bank, Standard Chartered … etc. A system of operations that consists of numerous components is what is needed to reach the standards.

In general, the components of an exemplary trade finance system of operations can be summarized under the following headings:

1. Setting proper organizational structure (Centralization of Operations).
2. Introducing the Bank's Instruction Manual (BIM) that contains the bank's policies, procedures, issuance guidelines, advising guidelines, limits of authority, relative circulars and notes for general circulation.
3. Setting a systematic method with qualitative measurement tools to evaluate LC's confirmation requests (credit and operational risk management).
4. Placing accurate procedures for discounting bills.

Setting a system of this nature is said to be the brain surgery of banking operations. This is normally a strategic endeavour of all banks and it requires the employment of large financial and specialized human resources over a reasonable period of time to be successfully concluded.

14.2 OPERATIONAL RISK ISSUES IN BANKING

Financial and commercial transactions are not the same everywhere. Each country has its own distinctive operational environment encompassed by a range of unique laws, regulations and practices formally inaugurated to protect the country's banking system against risks pertaining to a host of factors that have direct and indirect effect on the safety of its financial transactions; issues such as the country's socio-political environment, the language barrier, the efficiency of the legal system and the general standard of professional banking practice amongst the country's banks.

Today it is very common to see corporates moving their businesses to those banks who are known for their ability to complete LCs transactions accurately, this is because the risks of such transactions are considerably high and may well lead to the loss of the total value of the related contract, not to mention harming the reputation and integrity of the parties involved.

We have previously highlighted the LCs operational and fraud risks in the case of Emirates Bank v Credit Lyonnais to emphasize that the most complicated aspect of LCs operations is risk management. This is particularly true in areas like the Middle East for example where there are 22 countries with complex cultural, topographical, ethnic and religious diversity; a vast population of 400 million people situated between the Atlantic and the Arabian Gulf interacting within a variety of social, economic, political and legal systems.

14.2.1 Banking operations

Operational-wise, achieving peak performance at low risk rates is the natural consequence of two elements vital to the management process; (i) sound

strategic planning, and (ii) incorporation of international standard banking practice in routine day-to-day transactions. The second element entails the placement of a whole integrated system of operations that includes, amongst other components, procedural controls based on a full set of management instructions operative within a carefully engineered department set to achieve optimal operational efficiency whilst directing resources towards providing exemplary customer service and business development. Hence, management of operational risks in trade finance departments is mighty complex, especially when it is needed to adopt aggressive growth objectives and to provide distinctive customer service. The link between trade finance operations and the credit relationship management sections (credit facilities departments) makes risk management more complex.

14.2.2 The significance of the BIM

The full set of management instructions mentioned above is often called the BIM and sometimes referred to by the 'Bank's Holy Bible'. This is by far, the most important component of the bank's operational system. The BIM contains full definitions and descriptions of the bank's services/products, procedures, internal regulations, controls, functions, access limits, automation controls, major responsibilities and limits of authorities. Not only does the BIM provide a precise direction to accurately conclude daily transactions, it also serves as the means to allocate the exact accountabilities of the staff concerned when errors, deviations or fraudulent transactions occur. Amongst its other benefits, the BIM is truly the most important tool to detect and prevent fraud.

14.2.3 Specific risks

In addition to the operational risks outlined above, there are other types of risks the bank needs to be aware of in order to take protective measures whenever needed, as in the case of receiving requests to add the bank's confirmation to a letter of credit. In addition to the risks highlighted under Section 12.4.3 (Risk Factor) on performance standby LC for construction projects/civil engineering, the most obvious risk in standby LC operations is the risk of fraudulent drawing by the beneficiary on the standby which of course is borne by the applicant who can only seek remedy through legally pursuing the fraudsters. In developed countries like Europe, The United States of America and China the legal system would certainly be in favour of the applicant and a law suit in such circumstances usually does bring the fraudsters back to justice swiftly and effectively; unfortunately, the case may not be so in many other less developed countries where a legal action

can take years and years and may not finally achieve the justice sought by the applicant.

As for the other LC risks, these can be summarized under the following headings:

A. Risks pertained to the goods in commercial transactions: These are borne by the applicant of the LC and include short shipment, shipment of inferior goods, non-delivery and receipt of goods prior to receipt of documents which may force the applicant to take delivery of the goods by a shipping guarantee issued by its bankers. This means that the applicant will have to accept the LC documents under all circumstance and regardless of whether the documents contain discrepancies or not.

B. Foreign Exchange: Borne by the applicant of the LC. Whenever the currency of the LC differs from that of the country of issuance, the exchange rates may fluctuate between time of issuance and time of settlement to the disadvantage of the applicant especially if the applicant didn't arrange for a forward cover.

C. Failure of the issuing bank: Also borne by the applicant. If the issuing bank, for example, suffered insolvency and could not pay the beneficiary, the applicant will then have to do so.

D. Insolvency of the Applicant: Borne by the Issuing Bank.

E. Fraud risk: Borne by the applicant. This is where the beneficiary fraudulently ships worthless merchandise or doesn't ship any merchandise at all. In some other rare situations, the imposters forge a credit and advise it to the beneficiary who in turn ships the goods against a fraudulent bank undertaking. The beneficiary in such situations will not be able to claim from the issuing bank because it either did not issue the credit or it does not exist.

F. Sovereign and regulatory risks (sometimes called country risk): This is the risk where the performance of the documentary credit transaction is prevented by government intervention like in the case of imposing foreign payment restrictions or import/export restriction after the LC was issued.

G. Legal Risks: this represents the risk of legal actions against a party to the credit leading to the disruption of the performance under the LC.

H. Failure to comply with the credit terms and conditions. This risk arises when the beneficiary fails to present documents that comply with the credit terms and conditions and thus fails to collect the credit value.

I. Risks to the advising bank: In countries where the advising bank is required by law to produce an advice that accurately reflects what has been received and the advising bank fails to do so, then it bears the full responsibility of its negligence. Hence, the risk is operational. Further, in standby LCs subject to the ISP98 (Principle depicted by Rule 2.05 (a) (ii)) the same risk applies.

J. Risks to the nominated bank: This risk arises when a nominated acting bank within the scope of its nomination pays the beneficiary the value of documents presented and is found to be in conformity with the credit terms and conditions. However, the issuing bank upon checking the same presentation decides that they contain discrepancies. The risk here that the nominated bank may not get reimbursed.

K. The risks on the confirming bank: The confirming bank may not be able to obtain reimbursement from the issuing bank for LC value paid to the beneficiary against documents found to be in compliance with the credit terms and condition if the issuing bank decided after checking the documents that it contains discrepancies.

L. Risks to the reimbursing bank: The reimbursing bank is entitled to reimbursement from the issuing bank provided that it reimburses the claiming bank against a claim as specified in the issuing bank's instructions.

To account for the above risks, global banks have designed quantitative indicative risk-measurement tools by which the bank evaluates its applications to issue, advise or confirm an LC. Of course such tools are in addition to the operational procedural controls and BIM we talked about earlier.

In conclusion, although trade finance risk management is a mighty complex function, it is necessary for the continuity of the bank and as such it is a function given top priority by the bank's management. Risk management in banking has numerous dimensions the most important of which are (a) the legal risks addressed by lawyers, (b) the economic risks addressed by economists, (c) the socio-political risks also addressed by economists and bankers and (d) operational risks addressed by banking operations experts.

14.2.4 Quantifying operational risk

In trade finance banking operations, it is absolutely vital to quantify operations risk. Three major methods for such quantification were evolved as a result of the banks' needs to allocate reserves for operational risks: (a) correlating operations risk to work volume, (b) distribution of loss, and (c) other various types of self assessment.

14.3 RELEVANT DISCUSSION

14.3.1 Operations risk management and the basel 2 accord

Operations risk can be defined as the probability of loss resulting from a lack of operational controls, inefficient procedures, inadequate internal regulations, inefficient staff, lack of technical expertise, incompatible automation and other external events.

Operations risks need to be measured by all banks in order to provide the means necessary for managing risks and mitigating them effectively thereafter. The three 'globally' accepted methods for measuring risk pertaining to trade finance operations are as follows:

Operations Risk Correlated to Transactional Volume: This method is based on the hypothesis that the volume of losses is proportionately related to the volume of activities. Issuance of LC by SWIFT MT700 for example creates operations risk. The most common means currently used to identify work volume is the total fee income generated from the trade finance operations of the products sold/extended, or various processing activity levels such as transactions count or total number of vouchers. The simplest means is the Annual Gross Income of the bank. Under Basel 2 capital rules, this is called the basic indicator approach which equates operations risk to 15 per cent of the average positive gross income for the past three years. (Basel 2 also provides a standardized approach that applies operations risk assumptions ranging from 12 per cent to 18 per cent to eight defined lines of business).

Distributions of Loss: Calculation based on the Value-At-Risk Analysis (VAR).

The VAR represents the maximum amount that might be lost in a specified time period under a given degree of confidence. Statistically, the VAR is the probabilistic bound of losses over a specific period of time for a specific level of certainty. The specific period of time is called the holding period or the time horizon. The level of certainty is called the confidence interval. Both the holding period and the confidence interval can be selected to fit the needs of the analyst. For operations risk, the Bank of International Settlement (BIS) specifies a one-year holding period and 99.9 percentile confidence interval (thereby implying that all banks operationally must be A rated). The quantitative elements of Basel 2 Advanced Measurement Approaches (AMA) require the application of this type of analysis. In the United States of America, the Federal Reserve Bank requires all banks operating in America to analyze at least five years of internal operational – risk – loss data. (In contrast, BIS

provides for three years of data after the initial adoption of the approach and then five years).

Various Types of Self Assessment: This method depends on reviewing the bank's total exposure to losses from various types of errors. These reviews focus on all aspects of bank processes including policies, procedures, controls, oversight and audits. The AMA for operations risk under Basel 2 defines specific qualitative and quantitative elements. The qualitative elements within the AMA are an example of the self assessment approach. Both the Federal Reserves and the BIS require projections of loss distribution for multiple scenarios.

None of these three approaches summarized above is flawless. Let us consider each in turn:

Operations Risk and Volume Correlating operations risk to volume may be misleading. This is because volume does not reflect the operational standards of the bank which is a major component of risk assessment. Imagine there are two banks one of which has twice the gross income, twice the fee income and twice the volume for all activities of the other bank. According to the Basel 2 basic indicator approach, and all other methods for quantifying operations risk as a percentage of volume, the 'measure' would reveal an operations risk two times more for the first bank, twice than that of the second bank. But what if the first bank adopts international standard banking practice and places strict risk-control procedures and corporate governance while the second bank is a poor local bank with substandard practices and governance? It is very clear here that the measure of risk based on volume could be quite misleading and may not help in dwarfing risks.

Another clear example that further illustrates this point is the eruption of a fire at the management building of a bank's headquarters. The fire destroyed equipment and burned most of the documents and electronic records of the bank. This operational risk has occurred in several instances, the most famous of which is the 11 September tragedy of the World Trade Center in New York. It is obviously impossible to correlate the operational risk of terrorism and fire to gross income, fee income or activity volumes of the bank. The concern is ludicrous.

Hence, it is irrational to quantify operational risk in any way that attempts to capture event risks such as a fire or a terrorist attack. Reserves for operational risks are kept only for operational risks that can be measured by volume such as loans, LC … etc. By itself, this method is therefore incomplete.

Self Assessment Market surveys revealed that self assessments are the preferable method for quantifying operational risk. This tool is based on

anticipating the risk occurrence ahead of time and as such it constitutes a rough estimation of the probability of the said occurrence.

The previous example of fire prevention can serve as an effective illustration to understand the method of self assessment. Self assessment of fire prevention measures based on fire drills, for example, can help identify the possibility and severity of a fire but only in general ways. It would not be possible to precisely anticipate/project the probability of a fire let alone the destruction it may cause, but a rough estimation is sufficient to secure protective measures and allocate capital to face emergencies.

Self assessment for quantifying operations risk sometimes sounds a vague endeavour. Past experience reveals significant operations losses for which capital previously reserved was insufficient to meet. The famous example of the losses made by Barings Bank after huge losses resulting from baseless trading operation at one of its small branches located far from its headquarters may clarify the picture. Barings was satisfied with internal controls. Unfortunately they were mistaken to believe that.

Another example is an Australian bank, which a few years ago suffered considerable financial losses as a result of loose operational controls at one of its subsidiaries which also was remotely located in another country. The bank suffered credit loss from an inadequately controlled inventory loan to a bus company. The bank's reputation was also affected as the media openly criticized the shareholders. As a result, the bank's management 'improved' its controls and publicly stated that it 'now' has a healthy well controlled operational system. Yet in 2003, fraudsters at the main office took advantage of weakness in both risk-measurement and reporting systems to perpetrate a serious fraud.

Again, it is impossible to foresee two passenger jets flown deliberately into two huge buildings near your bank. It was said that the Bank of New York suffered $140 million in losses to its premises and equipment after the attacks of 11 September 2001. What self assessment method might have predicted the loss? How about Merril Lynch's legal settlement of a gender discrimination case?

In general, it is important to avoid assumptions based on current operational environment, that is, one must not be overconfident with regards to their institution's controls; history has shown that operational dilemmas often occur at banks whose managers are overconfident about their risk management measures. These are exactly the sort of managers least likely to contribute accurate information to a self assessment.

The Distribution of Loss Measures The VAR approach would not be suitable in all cases. This is because there is a need to obtain and apply samples of magnitude adequate to generate meaningful and useful results which may not be possible in business segments where there is little data of large losses.

The BIS and US banks realize the data limitation and accept data from external resources. Further, many banks are now collating and sharing collective (pooling) data bases for risk management analysis.

Once again, the main obstacles which banks face whilst setting forth their plans to mitigate and manage operational risks are the following:

1. For some lines of business, it is hard to find adequate statistical data for sampling purposes revealing large losses even with pooling the data of the whole banking industry. Furthermore, past history of loss experience of one bank with weak operational controls, does not necessarily reflect the future possibility of repetition for another bank adopting healthy risk management system. Another limitation on the use of pool data that banks, which previously suffered financial losses and eventually closed down as a result of high operational risks, did not exist at the time the data were pooled and as such the data is missing an important part that constitutes an effective indicator of possible future problems; these banks' operational loss history is not included in the analysis.
2. The relevance concern; the database gathered for risk analysis may contain data on losses suffered as a result of credit errors or any risks other than operational ones. Hence, these data if used to analyze operational risks may produce results of high error margins. In simpler words, a relatively high percentage of their credit losses may either result from operational errors or be exacerbated by such errors; according to Basel 2, such losses are credit related, not ops-risk losses. Global banks often encounter similar data obstacles with trading losses caused or worsened by operational errors.

VAR is a trading concept which is most effective when applied to adequate volume and upon correlating past history data sets. Data for operations losses seldom are adequately available.

The Better Approach Whenever there are adequate data available on past history, the self assessment, and loss distribution methods are quite useful. When data is not available, it is possible to improve these ways instead of abandoning them since they could be effective tools for quantifying operational risks. The self assessment approach depends on data sets which are biased and provide a subjective insight. The distribution of loss approach results from data shortfalls. There are, however, different approaches that can be developed to address the measurement concern rather than submit to erroneous information or impractical non-feasible assessments.

The better approach is based on analyzing the common factors which affect risks such as fraud, lack of operational controls and remotely located offices/branches/subsidiaries. The following step will be setting forth

predictive factors for the various types of operational risks, then applying linear regression tools to classify/weight those factors and anticipate/forecast future losses. Without any quantitative analysis, a rough estimation is that unemployment rates, inflation rates or some other economic indicators would be indicative of certain rises in delinquency ratios and a prediction to that effect should be made. To illustrate more clearly, it is rational to anticipate cash withdrawals by means of cheques or payment instructions bearing forged signatures, armed robberies in the less secured or protected banks' offices/branches and ATM break-ins in economic recession times. Another example would be the operations errors in loan documents or collateral/lien/securities controls which lead to losses only when the borrower defaults in settlement. Therefore, credit operations losses should also correlate to economic conditions.

Clearly, different anticipation/predictive factors apply to different kinds of operations risk. For some, distance from the main office will be a factor noting that most of the banks have centralized many of their operations especially their trade finance centres.

Small staff size should be a point of caution and indicates the possibility of internal frauds. The same applies for large staffed but unorganized banks with no segregation of duties and limits of authorities.

Best practice may dictate the application of the so called Queuing Theory to operations risk. Queuing Theory is the method based on calculating the probability distribution of event/client arrival, service times and length of the 'queues' of events/clients waiting for service. Effective as it is, the Queuing Theory goes back to 1958 and is based upon the work of the Nobel Prize winner in economics Kenneth Arrow. Queuing Theory is widely used by numerous banks for cash transactions efficiency and teller staffing optimization.

14.4 CONCLUSION

Operations risk management is the most important function of any bank management. It simply is the function without which a bank will most certainly diminish with time. It provides protective means against all kinds of operational risks ranging from simple human error to fraud, technological change, criminal terrorism, acts of god … etc. Not all risks can be measured, the consequences of a terrorist attack for example are impossible to measure. Nevertheless, most of the risks are measurable, dangers like automation failure, fraud, robbery … etc. are quite predictive. As such, quantifying operations risk needs to be based on a combination of objectives and subjective tools. International standard banking practice dictates the reliance on the latter and most global banks are therefore subjective

tools intensive. It is only logical to identify the immense importance of operational risk management for banks from the fact that operations risks were classified under Pillar one in the Basel 2 accord and before the Interest Rate Risk which was in Pillar 2.

Unless the bank's risk management method can clearly reveal potential operational dangers, it must be reviewed and amended seeking an effective one. This is only possible when one understands the practical limitations of applying any of the three principles. This is especially true for trade finance departments where the technical expertise of such departments are globally scarce albeit essential to prevent operational hazards. Risk managers in banks need to establish efficient and logical risk policies which will not only protect the bank from potential losses, but also at the same time avoid being an obstacle to achieving the growth objectives of the bank.

CHAPTER 15

Fraud Detection and Prevention

15.1 INTRODUCTION

Fraud is the most destructive illegal act banks face. Not only does it constitute a direct cost to the bank, it also entails large expenses for legal pursuits, investigation fees and cost of executives' time spent on handling fraudulent transactions. Furthermore, fraud has devastating negative effects, that cannot be expressed in terms of money, on the bank's reputation, public trust and staff morale.

The Commercial Crime Bureau of the ICC in Paris announced that the estimated volume of fraudulent Standby LC transactions is $10m a day. Its report, Prime Bank Instrument Frauds II, argues that law enforcement agencies and prosecution authorities are learning to cope with the increasing number of frauds perpetrated through the use of international banking facilities.

For banking professionals involved in LC transaction, it is absolutely essential to study some legal cases in order to understand the nature of commercial and financial fraud and thus develop the technical skills necessary to detect it and eventually prevent these crimes. You may feel a little deterred by the legal principles, quotations and court cases scattered throughout this chapter. However, an intensive effort has been exerted to summarize the cases so that they depict a practical banking view.

15.2 BACKGROUND

Fraud is the most destructive illegal act faced by parties to LC transactions. Recent cases in many parts of the world remind us of the numerous instances where multinational firms have closed down because of fraud. This chapter discusses the fraud detection under LCs and makes suggestions

for structuring LCs to help reduce the likelihood that issuing banks will find themselves involved in fraud-related LC disputes.

It has been reiterated on many occasions that courts are persistently reluctant to interfere in any documentary credit transaction. This is to preserve the integrity and reliability of the bank's payment undertakings that literally arose from such transactions. In simple words courts would seldom issue an injunction order (an order to stop the bank from paying the beneficiary the value of a complying presentation) upon the request of the applicant.

However, there is only one exception to this rule; courts will interfere whenever there is a clear and strong case of fraud. This approach of the law is often referred to as the Doctrine of Fraud which is best illustrated in the following quotation from a court in America 'This doctrine is an exception to the general rule that a letter of credit is independent of the underlying obligation it secures, and allows a court to enjoin payment under a letter of credit where a draw would amount to an "outright fraudulent practice" by the beneficiary.' Another court quotation confirms the Doctrine of Fraud:

'[A] court may enjoin payment on a letter of credit, despite the independence principle, where there is shown to be fraud by the beneficiary of the letter of credit…. Unfortunately, one unsettled point in the law is what constitutes fraud in the transaction, that is, what degree of defective performance by the beneficiary justifies enjoining the letter of credit transaction in violation of the independence principle?'

The following case studies provide sound practical reference for professionals to assist them in understanding the ways and means fraudsters normally follow in executing their criminal intentions.

15.3 FRAUD AND ISP98

Rule 1.05 of the ISP98 clarifies that fraud is to be handled by local law and by the bank whilst Rule 1.05 indicates that neither the Issuer nor the Confirmer are responsible for the genuineness of the documents presented under a standby. Hence if a forged document that appears to be genuine is presented and accepted by the bank, the bank is free of any liability. This is because the bank's duty is confined to checking the documents on their face to determine compliance. Further, the independence principle affirms such duty and precludes banks from searching beyond the documents for any fact represented by such documents.

The risk of fraud, if it takes place, is allocated by Rule 1.05. The basis for indemnifying banks against liability for fraudulent presentations which are not apparent as such is the necessity to preserve the integrity of the banks' undertakings with regard to payment against documentary credits. If banks are to be held liable for honouring documents which appear to be genuine

but are actually not, banks would cease to undertake any commitments under an LC transaction; a matter that would not only weaken the correspondent banking system in its entirety, but also a tighten wide scope of commercial and financial transaction. It is not exaggerating to say that the economy on a national scale would decelerate.

The similarity between the principles and procedures for handling fraud under commercial and standby LCs warrant discussing this topic in general terms that apply to both instruments.

15.4 THE INDEPENDENCE PRINCIPLE

The 'Autonomy of Documentary Credits' or the so called 'independence principle', briefly discussed at the beginning of this chapter, is the basic component to which the expansion of LC use around the globe is imputed. It represents the notion that the letter of credit is independent of the underlying contract it stems from. Further, the credit is also independent of the relationship between the issuing bank and the applicant. The issuing bank, the confirming bank or a nominated bank acting on its nomination is required to pay the beneficiary against the latter's presentation of conforming documents, that is, made in compliance with the credit terms and conditions and regardless of any external circumstances directly involving the applicant and the beneficiary, the applicant and the issuing bank or any other party or fact beyond the scope of the physical presentation of the documents itself.

It is useful to summarize a few basic principles of LC Law in order to understand the practical mechanisms of LC.

An LC is, stated simply, a promise, normally by a bank, to pay money to (or accept drafts drawn by) the 'beneficiary' for account of a customer (the 'applicant') – subject only to presentment to the Issuer of the documents called for by the LC.

The attractiveness of an LC from the point of view of the beneficiary is that if the documents he submits appear, on their face to comply with the terms and conditions of the LC, the bank is required to pay, regardless of whether there is a dispute on the underlying commercial contract. This rule is known as the 'independence' principle. It is fundamental to LC law and to the smooth flow of international commerce and conclusion of numerous financial transactions.

The independence principle may be simply illustrated by the following hypothetical case study which depicts both standby and commercial LCs. In real life cases, however, it seldom happens that a standby and commercial LCs are issued under the same transaction but this case is only drawn to illustrate the different uses of LC as a secured payment device in the world

of business and to understand some of the common ways by which fraudsters seek to fool the banks that issue LCs.

A doll manufacturer which we might name 'Rose Factory' has contracted to sell 10,000 Brand Jemini to Theo & Jake Distribution Company, Importer (herein called 'Jake'). The sales contract contains various specifications, including requirements as to the size, composition and appearance of the dolls. Payment of the purchase price is required to be made by way of a commercial LC supported by the security of an irrevocable standby LC, both issued by separate banks in favour of the manufacturer – to reiterate, in real life cases the beneficiary would demand the confirmation of the LC by a third bank as means of extra payment assurance instead of a standby LC, but for clarification purposes we have assumed the opposite – The commercial credit is duly issued and calls for presentation of a draft, an invoice covering 10,000 Brand Jemini, a clean on board ocean bill of lading and a packing list. The standby LC is also issued available at sight payment by the presentation of a draft drawn on the issuer and a certificate from Rose Factory stating that they have shipped the goods described in the LC and presented all required documents to the issuing bank in full conformity with the LC stipulations but didn't receive payment from the issuing bank.

Rose Factory makes the shipment and presents the required documents to Jake. Shortly after shipment, it comes to the attention of Jake that Rose Factory has shipped dolls with red hair – contrary to the sales contract, which called for dolls with black hair. Jake happens to believe that 10,000 red heads would receive a lukewarm reception in the home market; Jake wants the dark hair version that the contract prescribed.

Unfortunately for Jake, the independence principle means that if the documents comply with the LC, the bank must pay, and Jake will have to reimburse the bank and pursue the exporter for recompense regardless of whether the dolls have hair of the wrong colour, or other non-conforming features. In other words, the bank deals in documents, not in goods, and does not concern itself with the underlying transaction.

The independence principle applies under ISP98 to which almost all standby LCs are stated to be subject. The rule is highly comforting from the beneficiary's point of view, since he is normally assured of payment if his documents are in order, thus enabling him to shift any risks to the applicant and to deal with contractual disputes from a position of tactical strength.

How, then can Jake protect itself against outright, active fraud by Rose Factory in case he was unable to get Rose Factory to issue the standby LC mentioned earlier? In the hypothetical case above, what if the documents conform to the LC? But the dolls, rather than merely having non-conforming hair, had no heads – giving rise to the perfectly plausible argument that headless torsos should not be regarded as 'dolls' at all? What if the crates contained sawdust, rather than crates of dolls? The common use of today of

standby LC – which as discussed earlier are similar to guarantees and are often made callable by a simple demand – has only sharpened concern over possible fraudulent drawings.

15.5 THE EXCEPTION – FRAUD IN THE TRANSACTION

Courts will almost always deny the issue of a conjunction order to stop banks from honouring a complying presentation unless there is a clear and undoubted case of fraud, that is, even if the bank has doubts that the transaction is a fraudulent one, it is obliged to honour the presentation that appears on its face to comply with the LC stipulation.

In the case of Sztejn vs. J. Henry Schroder Banking Corporation, the importer discovered that the seller shipped 60 cases of caw hair and rubbish instead of bristles originally contracted to be imported from India. The seller managed to present a bill of lading and invoice describing the bristles called for by the LC; both documents appeared their face to be genuine. Upon discovering the fraud, the importer immediately requested the court to issue an injunction order (enjoin-prohibit) precluding the bank from paying the LC. 'The court issued a payment injunction and the bank therefore halted payment against the apparently compliant documents. This is another example that illustrates the independence principle which depicts the courts' reluctance to interfere in the letter of credit transaction unless there is a clear and undoubted case of fraud.'

The court emphasised that the case did not involve a mere breach of warranty (e.g., dolls with non-conforming hair) but on the basis of the pleadings, active fraud (e.g., no dolls at all). There is hope for Jake.

In the United States, based in part on the Sztejn case, the Uniform Commercial Code (UCC) recognises a fraud exception to the independence principle. section 5–114 of the UCC provides that if the documents conform but a required document is 'forged or fraudulent or there is a fraud in the transaction', a bank acting in good faith is entitled to make payment, even if it has notice of the fraud; but a court may enjoin payment of the credit, always assuming that the usual requirements for issuing an injunction, including demonstration of a likelihood of irreparable harm, are satisfied. (A few states' versions of the UCC do not include the reference to court action: the effect of this omission is not entirely clear, but it appears that courts in those states, in an appropriate case, enjoin the Beneficiary from drawing, if not the bank from paying). While the UCP does not contain 'fraud in the transaction' language, US cases generally recognise the availability of this defence for credits governed by the UCP. On an appropriate showing of fraud, an English court may also issue an injunction against

payment of a credit. Not withstanding the fraud exception, the United States and English courts are generally very reluctant to interfere with LC payments. This is entirely appropriate, after all the parties presumably bargained for the allocation of risk represented by the independence principle.

In light of the independence principle, it might appear that only the customer need be concerned with these steps. A number of the suggestions below will be particularly helpful to LC account parties. However, issuing banks are often dragged into fraud disputes as defendants in injunction suits brought by their customers. In addition, payment by a bank of a fraudulent LC demand is likely to result in creative efforts by the customer to show that the documents were actually non-conforming or that the LC bank otherwise failed to handle the LC properly. Banks must thus be equally concerned to structure LCs appropriately.

15.6 THE PROPER STRUCTURING OF AN LC

1. Assure that the LC terms are precise; this is an obvious and basic point. Precision is clearly in the interest of all parties, including the bank; the previous UCP500 actually contained two articles emphasizing the importance of precision, that is, Articles 5 and 12. Ambiguity in the description of the required documents can place the bank in the position of being sued by either the customer or the beneficiary, depending on whether payment is or is not made. (On the other hand, while precision is recommended, excess verbiage in an LC definitely presents other problems and should be avoided.)

   A case in Hong Kong, Udharam Rupchand Sons (HK) trading as Far East Confirmers vs. Mercantile Bank illustrates graphically the importance of clarity in an LC. In this case, Mercantile Bank, the Issuer of two commercial LCs, had made payments to Siam Commercial Bank and Thai Farmers Bank (who had acquired the documents from the original beneficiaries), and debited the account of the customer, Far East Confirmers. The underlying commercial transaction was a sale by Thai companies of leather goods and clothing to a company trading as Far East Confirmers, which was in turn acting at the instance of a certain Mr. Chao. According to the findings of the court, certificates presented under the LCs were forged and the goods shipped by the Thai companies were 'short delivered and wholly out of conformity with the specifications of the sales agreements'. This, the court of appeal said 'appears to have been the fruit of a collusive fraud involving Chao and the Thai companies'.

   The central legal question was whether the LCs were 'negotiation' credits – in which case the two Thai banks, as holders of the documents, were presumably entitled to claim on the LCs or rather 'straight' credits,

in which case they were not entitled to claim and Mercantile Bank's payment and debit were improper.

The LCs did not contain certain references to negotiation; for example, they provided: 'All banking charges outside the country of issuance of this credit including advising and negotiation commission are for the account of the beneficiary'. However, they were not clearly stated to be negotiation credits and in particular did not contain the standard negotiation credit language. 'We hereby agree with bona fide holders … .' The Hong Kong courts were critical of 'the imprecise character of the language used' and gave judgment for the customer against the bank.

2. Avoid reference in the LC to the underlying contract (Article 4 of UCP600). Inclusion in the LC of references to the underlying commercial transaction could destroy the independence of the LC and the bank's protection as an LC issuer. If it is necessary to include a reference to an underlying contract, it is desirable to indicate that the reference is for identification purposes only and that the underlying contract is not incorporated by reference.

3. Be wary of 'clean' credits. A clean credit is payable against a simple demand for payment, without any other documents. The Direct Pay standby LCs which we explained earlier take this form. Clean credits may facilitate fraud. It will be more difficult to prove that the beneficiary's drawing is fraudulent if the drawing was permissible without any certification by the beneficiary. Credits providing for payment against a simple unsubstantiated certification by the beneficiary as to non-performance on the underlying contract (sometimes called 'suicide' credits) also leave the parties vulnerable if there is a dishonest beneficiary.

4. Consider requiring a certification that demand has been made on the customer. Particularly in the case of standby credits, it can be useful to require the beneficiary to certify not only that the customer has failed to pay a stated amount when due, but that the beneficiary has made demand on the customer for such amount. The making of such a demand may give the customer a chance to react to an improper claim, while failure actually to make the demand will clearly render the LC drawing fraudulent and give the customer a basis for obtaining an injunction.

5. Require certification by independent parties. Third parties certifications can be very helpful. In the hypothetical case with which we began, if Rose Factory is required to present, as one of the documents called for by the LC, a certification by an independent analyst that the dolls conform to contract specifications, it will be more difficult for it to implement fraud. (Of course, collusion remains a possibility.) Jake as account party, may even be able to specify that its own certification or acceptance

certificate is a required document. This, however, deprives the beneficiary of one of the chief benefits of the LC and, in effect, overrides the independence principle.

Even if obtainable, it would be a mistake for Jake to assume that such 'vito power' will be absolute in all circumstances, as the beneficiary might (depending on the facts) be able to obtain a court order requiring Jake to produce the necessary certification. A specific suggestion to this effect was made in one US case, Corporation de Mercadeo Agricola vs. Mellon Bank, decided by the US Second Circuit in 1979. Some have suggested that from a bank's point of view, it may be better to avoid issuing LCs in which the account party has a veto on payment: It is interesting that at least one US judge (although he was on the dissenting side of the particular case) has said that such an arrangement is 'so contrary to conventional LC usage' that ordinary LC rules should not apply.

6. Watch out for Back-to-Back credits. A number of cases arising out of the crisis involving Iran and the United States, disclosed a pattern (common in the region) involving an Iranian bank as Issuer of a guarantee of performance or of advance payment refund, the guarantee being in turn, backed up by a US bank's LC in favour of the Iranian Bank. The problem for the account party on the US credit in such cases was that the beneficiary could draw on the credit merely by stating that its own guarantee had been drawn upon. In normal circumstances that particular statement will probably be true, not fraudulent, and thus there may be no basis whatsoever for enjoining the 'back-up' bank from paying.

   Since LCs issued in such circumstances are often in large amounts, and are not expected to be called, the result of a successful drawing is a sudden and potentially serious credit exposure to the customer at the very time that the customer is embroiled in disputes on the underlying contract.

   It should be pointed out that even in a situation of Back-to-Back credits, the account party may find a way to prevent the bank from paying. In some of the Iranian cases it was determined that the Iranian beneficiary bank's drawing was fraudulent – for example, because the beneficiary was deemed in collusion with or an inseparable part of the beneficiary of the guarantee. In a non-Iranian case, American National Bank and Trust Company of Chicago vs. Hamilton Industries International, decided in Chicago in February 1984, it was held that a French bank's demand under a back-up LC, which demand asserted that a call had been made under the French bank's own guarantee, was improper because the call on its guarantee was ambiguous and had in any event been received after banking hours on the termination date.

7. Consider restricting transfer of credit. Fraud of the most sordid variety on the part of the beneficiary may not prevent payment of an LC to an innocent party such as a bona fide transferee of a credit or a holder in due course of drafts drawn there under. The parties may, therefore, wish to consider providing that the LC is non-transferable. Under the UCP and the UCC, silence as to this point means that the credit is non-transferable, but it is better to state explicitly that it may not be transferred or explicitly designate a credit as transferable which is a requirement of Article 38 UCP600. Many banks require to express no transfer provision in all standby LCs as a matter of policy. In addition, the fact that a credit is a negotiation credit or confirmed credit may complicate the account party's position, since this may mean the draft and documents will be presented by an innocent negotiating or confirming bank. Straight credits (in which the bank's engagement runs only to the beneficiary) are in this sense, preferable. This is demonstrated by the Hong Kong case noted above.

   A case decided by a court in Louisiana in May 1984, Cromwell vs. Commerce & Energy Bank of Lafayette, involved an LC guaranteeing promissory notes issued by investors in limited partnership, covering the balance of their contributions to the partnership, the notes and the LCs being assigned by the payee or beneficiary to another bank as a security for the financing of the venture. The underlying investment went bad, and the inevitable US securities laws allegations by the investors (account parties) followed. The investors requested injunctions against payment of the credits. The court had to determine whether 'fraud in the transaction' was involved within the meaning of Louisianna LC law (Louisiana is the one state that has not adopted the UCC, but it has analogous statutory provisions on LCs). It was held that the injunction should be disallowed on the ground that 'fraud in the transaction' did not include fraud in connection with the underlying investment. It may be that an important factor underlying the ruling was that the LCs has been transferred to an innocent third party, namely the financing bank.

8. Consider including force majeure or termination provisions in the underlying contract. This will not be normal in the Rose Factory/Jake type of contract, but it may be possible in connection with long term sales or construction contracts. Some of the Iranian cases suggest that if the underlying contracts have been validly terminated, and especially if the relevant termination provision itself contemplates the release of related guarantees or LCs, it may be easier to persuade a court that the LC drawing is fraudulent. 'In the case of Itek Corporation vs. First National Bank of Boston, decided by the US First Circuit Court of Appeals in March 1984, the underlying sales contract stated that upon force majeure

the contract terminates', 'all bank guarantees of good performance' will be released force majeures (defined to include revocation of a US export license, as occurred in the Iranian crisis) having been invoked, the subsequent drawing on the LC was found to be fraudulent.

9. Avoid waiving rights. If it is too late to seek an injunction, the account party might seek to refuse to reimburse the bank on the ground that there is a discrepancy in the documents. The account party will wish to avoid any course of action (such as exercise of dominion over the documents or goods, or any statement or course of action implying consent) that may be deemed to constitute a waiver of such a claim. The other side of this coin is the importance for the issuing bank of reviewing the documents with care to assure that they appear on their face to comply with the credit. As an English judge has written, there is no room for documents that are almost the same or that will do just as well. (In one US case a bill of lading listed the party to be notified as 'Mohammed Soran' rather than 'Mohammed Sofan' as required by the LC; the court held that this discrepancy was enough to excuse the bank from paying.) In addition, the bank must be careful not to waive defects in the documents or put itself in the position of being estopped to assert them. Under some circumstances, mere delay can constitute a waiver.
10. Other protections. Other measures might be possible in certain types of LC arrangements. For example, LCs can contain step-down provisions, by which the exposures on the credit decreases as performance on the underlying contract occurs, each decrease being triggered by specified certificates or other written statements delivered to the issuing bank; this does not alter the account party's legal situation so much as it decreases financial risk as the underlying transaction proceeds.

Beneficiaries may be asked to consent in advance to count jurisdiction in the event of LC related suits. Measures of these types are most likely to be practical in the context of a standby credit than the typical commercial credit.

Notwithstanding the predicament of Jake, it is well known that courts will intervene to prohibit payment of LCs only in exceptional situations where, as one US court put it, the wrongdoing of the beneficiary has so vitiated the entire transaction that the independence principle no longer serves its purposes. The measures outlined above can help avoid major disputes.

15.7 THE CASE OF EMIRATES BANKS

The *Emirates Bank International* – Dubai opened a 180-day deferred payment LC for USD851,700 to import 25,000kg of silver alloy and requested

Credit Lyonnais (Suisse) S.A. to advise the LC to beneficiary adding its confirmation. Credit Lyonnais confirmed the LC and advised same to the beneficiary. The LC did not specify that it was subject to UCP500. In fact it was silent as to governing rules.

The beneficiary presented to the confirming bank documents that appeared on its face to comply with the credit terms and conditions. The confirming bank checked the documents, affirmed its compliance with the LC stipulations, undertook to honour it on maturity and forwarded it to the Issuing Bank. The confirming bank then, upon the beneficiary's request, immediately discounted the value of the documents by paying the beneficiary said value less its charges and discount rate. The discount transaction was without recourse on the financial risk only meaning that the confirming bank's risk was limited to country risk and risk of Issuer's insolvency.

On receipt of the documents, the issuer endorsed the bills of lading and delivered them to the Applicant against a promissory note equal to the amount of the LC. The issuing bank then notified the confirming bank that it had found the documents conforming to LC terms, that it had taken up said documents and that it would pay its value on the due date.

Later on, the confirming bank heard rumours that the applicant could be a dishonest person and the LC in question might well be a fraudulent one. The confirming bank warned both the beneficiary and issuing bank of such rumour.

The issuing bank immediately requested the ICC's International Maritime Bureau to check the goods of the LC. The Bureau report revealed that the two containers involved did not contain goods in compliance with the agreement. The investigation also revealed that transactions financed by the beneficiary, including the one in question in this case, were fraudulent in that either no goods had been shipped or what was shipped had a much lower value than what was claimed. The excess money was misappropriated by the applicant and the total loss was estimated to be USD300 million.

Although beneficiary was listed as 'Seller' in the LC, in fact it was a financial intermediary that did not participate in the delivery of the merchandise. It did, however, know that the sale was fictitious. Criminal complaints were filed by the issuing bank in Geneva against the beneficiary's officers. After the fraud was revealed, the issuer filed a motion for interim relief in Geneva to prevent the confirmer from claiming reimbursement under the LC on maturity date. The court dismissed its motion. On the due date, the issuer refused to reimburse the confirmer.

15.7.1 Applicable law

The confirmer then sued the issuer for reimbursement by filing a request for payment from the issuer in the Swiss courts in Geneva, seeking the amount

it was owed under the LC plus interest. The local court granted judgment for the confirmer. On appeal to the intermediate appellate court, affirmed. On appeal the judgment for the confirmer was overturned and the Emirates Bank International won its appeal.

After cautious study of previous courts decisions on similar issues, the court decided that the confirming bank should bear the risk of fraud proven subsequent to it discounting the amount of the transaction. It was stressed that the term 'Deferred Payment' means payment will be made after presentation of the documents in a period exceeding the time allowed for checking the documents.

'… Whilst recognising that either the issuer or confirmer can prepay the amount owed, the court stated that being able to prepay would not, nevertheless, allow the bank that paid before the due date to unilaterally amend to its own benefit the terms of the letter of credit with deferred payment, when as provided by section 9d/i UCP500, once opened, the irrevocable documentary credit may not be amended without the agreement of all parties.'

If the purchaser or the issuing bank, in the case of a four-way relationship, is denied the possibility to claim a fraud discovered after the prepayment to refuse repayment to the appointed confirming bank on the due date, the latter is left to unilaterally protect itself against such risk. It would suffice to discount the letter of credit as soon as possible after accepting the documents to avoid any objection related to fraud discovered subsequently.

15.8 PROCEDURES FOR FRAUD PREVENTION

To stimulate trust and acceptance, fraudsters often seek to show reputable banks as parties to their fraudulent transactions. These kinds of deceptive perceptions should always raise doubts and suspicions as to the legitimacy of the transaction in question. Care in such circumstances should be taken and the transaction must be thoroughly scrutinized.

Staff handling the transaction must also report it immediately to their supervisors and/or the Compliance Executive. Reporting is essential to prevent or recover losses if any and to arrest the fraudsters.

A banker should always avoid doing the following in protecting him/herself from fraud:

1. Do not let the customer place you under any pressure to lead you into making unusual or impulsive decisions about any type of banking transactions or proposals that you doubt or do not fully understand.

2. Never discuss the internal regulations and procedures of the bank especially with 'interested' strangers as they may be researching into how to perpetrate a fraud.
3. Do not issue letters introducing persons or confirming transactions.
4. Never sign any papers without being fully aware of their contents and implications.
5. Never reveal account details to unidentified/unauthorized individuals.

Banks normally fall into fraud in the following areas:

1. Commercial Fraud (Standby LCs, Commercial LCs, Guarantees and Collections)
2. Cheques Fraud
3. Credit Card Fraud
4. Internet Fraud
5. Credit Fraud (Loans, ODs or facilities/borrowing fraud)
6. Telex Fraud
7. Staff Fraud

Staff Fraud: In more than 63 per cent of the fraud cases detected by banks in the Middle East, the fraudsters were actually relatives of the same family, that is, first and second cousins and sometimes husbands and wives who worked in the same banks and even in the same divisions or departments. In one case it was noted that a senior executive at an international bank promoted his direct cousin to an executive rank to increase the scope of their authority. Relatives facilitated fraudulent transactions for each other. It is this specific reason that makes major banks persist on prohibiting the employment of relatives.

Fraudsters sometimes are so powerful to the extent that they get around the bylaws of even the world's most reputable banks. In one case it was noted that the fraudsters altered the staff handbook that contained the bank's HR recruitment policy on employment of relatives and wives/husbands. By doing so the relatives maintained their authority and preserved their informal societies; in the same bank a top senior executive, two of his direct cousins, his wife's sister and three indirect cousins were working together. It was almost impossible for their management to realize what was happening since they were all British. In one incident they facilitated a fraud of $25 million and actually managed to escape liability.

The most common type of fraud is the commercial fraud, including of course standby LC as we saw earlier. In some countries, banks incur billions

of dollars every year in fraudulent LCs. In 2001, Saudi Arabia alone suffered a loss of over two billion dollars worth of fraudulent trade finance transactions.

In almost half the cases classified under this type of fraud, one of the fraudsters was an executive at the bank that granted facilities to the fraudsters and either directly or indirectly influenced the facilities approval process.

Many of us have also run at one time through the Nigerian or West African letters which are frequently circulated on a mass scale and sent out from countries in West Africa inviting recipients to assist the writer to remove funds that do not exist illegally from the country. The purpose of the letter is to get the writer to provide his account details and signature so they can steal money from his account. The fraudsters may also request the victim to pay money before agreeing to release the fund.

Other dubious fraud attempts involve Currency Scams, Lost Treasures, Gold Deals, Huge Inheritances, Prime Bank Guarantees, Financial Instruments, Safekeeping Receipts, Back-to-Back Transferable LC, Shell/Bogus Banks and Funny Money.

Most of these frauds are made possible by either failure of the bank to lay down a set of sound effective procedures and regulations in a formal instruction manual inaugurated by the bank's top management team, or failure by the staff to observe and abide with such a manual if already laid down. In the previous chapters we highlighted the importance and the necessity of the BIM to detect and prevent fraud.

CHAPTER 16

Presentation and Settlement

16.1 INTRODUCTION

The standby letter of credit is a financial and commercial instrument of a documentary nature. The beneficiary can only avail itself of the benefits of the instrument if it was able to comply with the terms and conditions stipulated by it and at the same prove that it has done so by presenting the set of documents in conformity with the credit stipulations.

In Chapter 5, we have discussed in detail the general procedures followed by banks in examining documents presented under a standby letter of credit, and we tackled each of the provisions of Rule 4 of the ISP98. In this chapter, we will also examine the process of presenting documents itself and tackle the options available for banks in handling the presentment in accordance with the standard set by the ISP98 and supplemented by the international standard banking practice, since the ISP98 are interpreted as mercantile usage with regard for consistency within the worldwide system of banking operations and commerce; and world wide uniformity in their interpretation and application.

16.2 STANDARD FOR EXAMINATION OF DOCUMENTS – OVERVIEW

The process of determining compliance of the presentment of documents depends on how documents appear on their face, Subrule 4.01 (a) so states. Whilst Subrule (b) indicates that the terms and conditions must be supplemented and even interpreted by the ISP98 itself which represents the international standard banking practice pertaining to standby letter of credit. It is interesting to note that the newly inaugurated UCP600 followed the ISP98 and avoided using the notion that banks must exercise reasonable care

whilst checking the documents to ensure that they comply on their face with the credit stipulations; this is because the test in determining compliance is not whether or not the bank exercised reasonable care, rather it is whether the documents comply.

In this regard, it is useful to read the following quotation from the ICC's Publication 511 – Documentary Credit UCP500 and UCP400 compared:

> Reasonable Care – Currently the notion of reasonable care is usually applied by courts, regardless of the legal system or geographic location, in conjunction with the doctrine of 'Strict Compliance'. Yet, as any experience banker knows, a word-by-word, letter-by-letter correspondence between the documents and the credit terms is a practical impossibility. Thus, courts wedded to a 'mirror image' version of strict compliance and reasonable care have failed to provide a functional standard of document verification. Conversely, courts that interpret strict compliance as allowing deviations that do not cause ostensible harm to the Applicant, or that do not violate the court's own version of 'reasonableness', 'equity', 'good faith', or 'boni mores', have equally failed to provide a functional standard. These courts' decisions rely on a case by case analysis, and such an analysis does not lend itself to generalization. Not having such a functional standard of verification to be used in conjunction with strict compliance has resulted in a proliferation of credit litigation and in costly uncertainty throughout the documentary credit world.
>
> Since Documentary Credit banking is competitive and co-operative endeavour, to succeed in it banks must develop customs and practices that encourage their customers' and correspondents' trust. Sharp, dishonest or negligent practices are invariably short lived and do not constitute good international standard banking practice. International Standard Banking Practice for Documentary Credits contains the rules that embody honest and predictable practices.

Another practical aspect of standby LCs operations is the process of checking the documents against one another, in addition to checking the documents against the text of the standby letter of credit, in order to determine compliance. Rule 4.03 of the ISP98 provides that this is only allowed if the terms of the credit so stipulate.

Practically speaking, it is impossible to determine the desired or expected level of consistency between the various documents presented under the same standby letter of credit. This is because there isn't necessarily a predetermined obligation in the standby letter of credit.

Further, since the documents frequently cover default situations, it is expected to have inconsistencies between documents once the presentation

is made (normally containing the documents requiring performance together with those evidencing default).

The fact that extraneous documents are often included in standby LCs' presentations do not add any burden on the nominated bank, confirmer or issuer responsible for checking the documents. This is because documents not required by the credit can simply be ignored; these may be returned to the presenter or forwarded as an addition to the issuer without any responsibility. They, as their name suggests, are extraneous documents. Rule 4.02 provides that extraneous documents must be disregarded in the examination process.

The provisions pertaining to the timing allowed for examining documents are regulated in several subrules in the ISP98 which tackles the issue of timing in a precise and comprehensive manner. These rules, explained in detail in Chapter 6, generally encapsulate the following provisions:

1. Subrule 5.01 (a) defining time that is not unreasonable.
2. Subrule 5.01 (a) (i) setting the seven business day limit and introducing the notion of three days safe harbour. The ISP98 Subrule 1.09 (a) defines business day as the day when the relevant place of business is regularly open for business.
3. Subrule 5.01 (a) (iii) provides for the calculation of time. It states that the seven banking days period starts on the day following the day of receipt of the documents by the bank.

16.2.1 Documents checking – basic steps in checking documents

The basic steps to be taken in checking any presentation of documents under a standby letter of credit are the following:

A. Determining the availability, workability and eligibility of the credit

Upon receipt of the set of documents, the examiner must first check the following items:

1. The remitting bank covering schedule enclosing the documents stipulated by the credit. The checker should authenticate the signatures of the bank's authorized signatory and carefully review the content of the schedule in case there is any specific notation regarding the credit documents.
2. The beneficiary's covering letter enclosing the documents. To determine the capacity of the presenter, check any internal black lists and ensure

whether there are any specific internal regulations governing the transaction.

3. Other extraneous documents attached to the presentation such as compliment slips or unidentified slips.

B. The Method by which the Credit is Available

1. The examiner must first ensure that the credit number is correct.
2. The credit is still valid and it has not expired.
3. The drawing is not in excess of the available credit amount.
4. The balance of the credit is accurate; previous drawings have been recorded.
5. All amendments are on file.

C. The Settlement/Payment Instructions

1. The examiner must ensure that the settlement instructions are included on the presentment covering schedule, that is, how and where should payment be made.
2. Party responsible for paying the charges and fees.
3. By which method the advice of payment should be sent.

D. Discrepancies Previously noted by the Advising/Nominated/ Confirming Bank

It is important to read the covering schedule of the presenter and make note of any discrepancies previously spotted and any additional comments related to these discrepancies.

E. Workability of the Credit

The must ensure that the stipulated documents are all within the means and control of the beneficiary so that if it plans to draw on the credit it can do so by merely presenting documents which can freely prepared by it or easily arranged for without any hassle.

F. Recording

The examiner must ensure that the contents of the presentation actually tally with the contents specified on the covering schedule. Further it should

check that the office which received the presentation has stamped it with the Date and Time Received Stamp.

16.2.2 Determining the bank's specific role in handling the presentation

As explained in the previous chapters, the bank may undertake various responsibilities with regard to the standby letter of credit it advises, the various roles of banks acting under a documentary credit transaction are:

The Issuer

The Advisor

The Confirmer

A Nominated Bank Acting upon its Nomination; the nominated bank acting upon its nomination is called after the function it accepts to perform, that is, the paying bank if the credit is available by sight or deferred payment, the accepting bank if the credit is available by acceptance or the negotiating bank if the credit is available by negotiation.

This takes us back to Rule 2.04 providing basics for nomination and Rule 8.01 (b) providing for the rights to reimbursement of the various parties to the documentary credit transaction.

16.2.3 Determining the type of credit at hand

The examiner must then determine the type of credit it is checking. The various types of standby LC with regards to the availability of the credit are:

Available at the counters of the issuer and/or with the nominated bank

Available at sight payment

Available by deferred payment

Available by acceptance

Available by negotiation either at sight or at a future date

A transferable credit

An evergreen or revolving standby

At this early stage it is advisable that the examiner checks against the text of the standby letter of credit the presenter's settlement instructions in order to ensure that they do not contradict each other and to ascertain that the settlement instructions can be complied with.

Regarding the evergreen and transferable standby LC, it is also essential to review the bank's internal instructions and regulations to ascertain that there are no restrictions in handling these special types of credit.

16.2.4 The bank's examination record

Every standby letter of credit file must contain a Document Examination Record. This is a simple form used to record the discrepancies noted upon checking the documents presented under the standby, the discussion with the presenter regarding the documents presented and communications with parties other than the beneficiary. The Record literally aims at registering the details of the all events related to the presentation of documents from the moment the documents are received, through the examination process to the settlement or rejection decision.

In many banks, the Record requires more than one signature depending on the amount of the standby letter of credit, for example, credits with value exceeding $5000 will require to be checked and results validated by two authorized signatories.

The Document Examination Record varies in form and content from one bank to another. Nevertheless, the main fields are:

Credit number, amount, expiry date, latest date for presentation of documents.

Terms of settlement.

Details of discussions with beneficiaries, confirmer or presenters … etc.

Discrepancies spotted upon documents examination.

Signature of document checker and other authorized signatories.

The Record is of immense importance especially when there are disputes based on the validity date, receipt of documents, curing discrepancies … etc.

Bank's Examination Record

Standby LC No.: EXPvJSCS7754 **Date:** 12 Jan 2010

Date and Time of Receipt of Documents: 12 Jan 2010 Hr: 10:24am

Issuer: Commercial Bank of Dubai **Reference Number:** CBDNvJ-779943

Amount of Credit: $7000 – **Amount Available:** $7000 – **Presentation Amount:** $7000.

Beneficiary's Reference Number: BEMO16421 **Charges:** For Applicant's Account

Expiry Date: 24 Dec 2011 **Partial Drawing:** Not allowed

Type of Credit: Tender Bond for construction Project MERBMPO7

Discrepancies:

1. Applicant's name on claim differs from that on the credit.
2. Credit overdrawn.
3. Credit expired.
4. Copy of invoice not presented.

Action Taken:

1. Beneficiary notified; Advice of Dishonour sent on 14 Jan 2010.
2. On 15 Jan 2010, called Mr. John Smith of BEMO Construction and discussed the discrepancies. Mr. Smith verbally demanded that we contact the issuer for the purpose of obtaining the applicant's waiver of discrepancies.
3. On 15 Jan 2010, A SWIFT message MT754 – JSCS7754 (copy on file) was sent to the Commercial Bank of Dubai requesting them to contact the applicant for their waiver of discrepancies.
4. On 16 Jan 2010, Commercial Bank of Dubai replied positively (MT754-CBD-1-CBDNvJ-779943) advising that the applicant approved waiving discrepancies and therefore authorized us to effect payment to the beneficiary deducting our due charges.
5. Payment made on 16 Jan, 2010 and documents dispatched to issuer on same date.

Settlement:

In reimbursement, we have debited on 16 Jan 2010 the account of Commercial Bank of Dubai number 998-887JSCS-11912CBD with us for $7300 – being the full value of the drawing plus $300 – our charges.

16.3 THE GENERAL PROCEDURE FOR DOCUMENTS EXAMINATION

16.3.1 The fundamental requirements of the ISP98

A. International Standard Banking Practice on Standby LCs The exact requirements for checking documents under ISP98 were fully discussed in Chapters 5 and 6 which must be reread in full before moving on to this chapter.

The standards by which documents must be examined are provided for in Subrule 4.01 of the ISP which states that drawings under the credit must comply with the terms and conditions of the standby and indicate that determination of apparent compliance is based on examining the documents presented under the standby letter of credit on their face against the standby stipulations as interpreted and supplemented by the provisions of the ISP98. The provisions of the ISP98 constitute the standard banking practice for handling standby LC.

B. The Apparent Authenticity of the Documents – The Face of the Documents The documents checker need not investigate the facts and/or figures represented by the documents beyond the face of these documents to determine compliance. As long as the documents appear on their face to conform to the credit stipulations and the provisions of the ISP98, then they must be honoured by the concerned bank.

C. Inconsistencies It is seldom required that documents presented under a standby letter of credit be consistent with one another; documents must only be consistent with the standby itself. If the credit, however, requires such consistency, such requirement must be stipulated in the text of the standby.

D. Language The language of all documents constituting the presentment must be that of the standby letter of credit.

E. The Issuer of the Document Unless the standby letter of credit stipulates otherwise, any document presented under the credit must be issued by the beneficiary itself.

F. Date of Documents The date of any document presented under a standby letter of credit must not be after the date of the presentation of such document.

G. Signature Unless otherwise stipulated by the credit, a required document need not be signed.

H. Identical Wording The extent to which the wording of the documents presented under a standby letter of credit need to be identical to the text of the standby is dependent on the stipulations of the standby. Rule 4.09 encapsulates the cases that may be demanded by the standby.

I. Workability The standby must be available by the presentation of documents the issuance of which is within the ability of the beneficiary. It should not require documents issued, signed or counter-signed by the applicant. It is the duty of the advisor to warn the beneficiary of the complexities and dangers of the inclusion of such documents.

J. Non-Documentary Conditions A non-documentary condition in any standby letter of credit must be disregarded.

K. Formalities Unless otherwise stipulated by the credit, any document or formality in a statement need not be officialized or formalized in any way.

L. Timing The time for checking documents presented must not exceed seven business days following the receipt of presentation by the bank responsible for checking them. In some cases, it must not exceed three banking days depending on the definition of reasonableness of time with regard to checking the presentment within the circumstances prevailing at the relative bank's environment.

16.3.2 The procedure for checking the documents on their face to determine compliance

1. Verify the authenticity of the credit.
2. Go through all fields/components of the standby operative instrument.
3. Update all valid amendments on the original credit.
4. Check the 'Additional Conditions' and any special terms.
5. Tally the documents against the credit stipulation to ensure that none of them is missing. Only afterwards start the examination process against the terms and conditions of the standby letter of credit supplemented by the ISP98 stipulations.
6. Honour the presentation as per the credit terms if it was compliant.
7. If the presentation was discrepant, write down any discrepancies spotted on the Documents Examination Record and thereafter issue a notice of dishonour as per the provisions of Rule 5.01, 5.02 and 5.03.

The examiner of any set of documents must always remember that it is not possible to cancel or amend a credit without the agreement of the issuer, the confirmer, if any, and the beneficiary. This is the rationale behind Rule 1.06 (b) which affirms the binding irrevocable character of the standby letter of credit.

The examiner must also remember the provisions of Rule 2.06 providing that an amendment which is not automatic, binds the issuer the moment it is released or when it leaves the issuer's control; and the confirmer when it leaves the confirmer's control; and the beneficiary when it expresses its consent to the amendment or alternatively when it presents documents which comply with the terms of the amended standby letter of credit.

The principle of independence which we went through in Section 15.1.3 is illustrated in Rule 1.08 which disclaims the bank's responsibility for performance or breach of any underlying transaction; the effect of documents, actions of others, inaction of others, or the observance of foreign law or practice.

The remaining rule of relevance to the work of the documents checker which must be remembered is Rule 8.01 (b) (ii) (Right to Reimbursement) which provides for the responsibility of both the issuer and the applicant to reimburse the parties of the documentary credit transaction and detailing the risks for which the applicant is responsible to indemnify the issuer in addition to indicating the right of the issuer for reimbursement by the applicant whenever the former performs the duties of the confirmer who wrongfully dishonour a confirmation.

16.4 PROCESSING OF DISCREPANT DOCUMENTS BY THE ISSUER

16.4.1 Request to waive discrepancies

If the presenter after receipt of notice of dishonour requests to forward the discrepant documents to the issuer (which also includes a confirmer) and demands that the issuer seeks applicant's waiver of discrepancies, the issuer may on its own discretion do so. Conversely, if the issuer elects not to seek the waiver of the applicant, this is entirely up to it. In both cases, the provisions of Rule 5.06 apply in its entirety.

There are occasions where the issuer chooses to approach the applicant, in its sole discretion, and without any authorisation from the presenter to waive the discrepancies in the presentation or otherwise authorise honour within the time available for giving notice of dishonour. In this situation, the provisions of Rule 5.05 apply in full.

In practice, the beneficiary of the standby letter of credit often draws on the credit whenever the applicant defaults to carry out a certain duty previously

agreed upon with the beneficiary. Hence, it is highly unlikely that the applicant will waive the discrepancies especially in those cases where the standby letter of credit depicts a default situation. Nevertheless, there may be other types of standby LC with uses covering a performance rather than a default situation. In such cases, the beneficiary would directly contact the applicant and arrange for a waiver of discrepancies long before the issuer or the presenter via the issuer contacts the applicant.

Occasionally, the issuer may avoid contacting the applicant at all and dispose of the presented documents directly by returning them to the presenter. This type of practice does not reflect professionalism on the part of the issuer neither does it indicate courtesy; rather a rigidity that often causes loss of valuable opportunities.

16.4.2 No waiver obtained

Where the applicant refuses to waive the discrepancies, the issuer must carefully apply the provisions of Rule 5.01 (providing how to calculate the time for a notice of refusal, and 5.02 demanding that all discrepancies for which the notice of refusal is given be listed). To reiterate, care must be exercised to observe the provisions of Rule 5.03 which imposes severe penalties on those banks which fail to abide with its requirements.

16.4.3 Disposition of discrepant documents

Upon receiving the notice of dishonour from the issuer, the presenter, depending on the discrepancies, may attempt to deny these alleged discrepancies either for legitimate reasons or to prevent assertion of them. Several communications between the two parties will take place until someone admits to the responsibility and acts accordingly, or the dispute may be taken to higher authorities of the banks for further action which may be legal.

Upon receipt of the bank's acknowledgment, the applicant and beneficiary may actually agree to resolve the dispute peacefully between them without having to refer to law. If the dispute is not resolved, the issuer must arrange for the disposition of documents and therefore it seeks the instructions of the presenter in this regard. Here, Rule 5.07 applies. The rule provides that dishonoured documents must be returned, held or disposed of as per the instructions of the presenter. Until such instructions are received, it is wise to maintain the documents in a secured fire-proof Chubb safe.

16.4.4 Handling of pending dishonoured documents

On some occasions, the applicant may not wish to waive an alleged discrepancy and at the same time the beneficiary may also insist that the

documents are compliant and the alleged discrepancy is in fact not a discrepancy at all. Here, the beneficiary may refuse to collect the documents and could insist that they remain in custody of the issuer until the dispute is resolved.

Pending documents of the kind are always kept at the disposal of the presenter and held under the bank's safe custody pending receipt of instructions from an authorized person. Some banks with high trade finance business volumes have a separate department specializing in handling pending cases and overdue transactions.

To avoid any responsibility on the bank, the issuer must always ensure that these documents are not collecting dust on a counter and are readily available for dispatch to the presenter upon request. It is also imperative to carry out a periodic physical check on these files and record the process with a brief comment on recent development or non development on the mandate file. It is also advisable to send a short advice to the beneficiary of the developments or non-developments pertaining to the transaction. Today most banks have these pending and overdue advices generated automatically.

On this same subject, it is useful to recall the content of Subrule 5.06 (iv) which provides that the issuer must hold the documents until it receives a response from the applicant or is requested by the presenter to return the documents, and if the issuer did not receive such a response or request within ten business days of its notice of dishonour, it may return the documents to the presenter.

16.5 PROCESSING DISCREPANT DOCUMENTS BY A NOMINATED BANK OR CONFIRMER

The beneficiary frequently presents the documents to a nominated bank acting upon its nomination, that is being the agent of the issuer since it expressly agreed to pay, incur a deferred payment undertaking, accept or negotiate documents. It also presents the documents to a confirmer if the standby letter of credit is confirmed.

The principles governing the process of examining documents by the issuer identically apply to the nominated person or the confirmer. These were fully examined in Chapter 5. It is useful, however, to reiterate some of these fundamentals. The independence principle always governs any process of checking documents; documents checking is independent of the underlying contract that gave rise to the credit. Further, the checking process can never be affected by the beneficiary-applicant relationship or by the applicant-issuer relationship; it is also independent of the actual default or performance of the underlying service.

The responsibilities of the nominated and confirming banks under LC transactions had been strongly stressed in the following paragraph quoted from the ICC Guide to Documentary Credit Operations ICC Publication 515:

Irrevocable Negotiation Documentary Credit – Definition

Under the Irrevocable Negotiation Documentary Credit, the Issuing Bank's engagement is extended to third parties who negotiate or purchase the Beneficiary's Draft/Documents presented under the documentary credit. This assures anyone who is authorized to negotiate a draft/document that these drafts/documents will be duly honoured by the issuing bank provided the terms and conditions of the documentary credit are complied with. A bank which effectively negotiates drafts/documents buys them from the beneficiary, thereby becoming a holder in due course.

Irrevocable Confirmed Documentary Credit – Definition

A confirmation of an irrevocable documentary credit by a bank (the confirming bank) upon the authorisation or request of the issuing bank constitutes a definite undertaking of the Confirming Bank, in addition to that of the Issuing Bank, provided that the stipulated documents are presented to the Confirming Bank or to any other nominated bank on or before the expiry date and the terms and conditions of the documentary credit are complied with, to pay, to accept draft(s), or to negotiate.

You may have noticed the difference between the general approach for presenting documents under a commercial letter of credit subject to the UCP and a standby letter of credit subject to the ISP98. The presentment of documents under a standby letter of credit was addressed in Section 13.5.2 'The Beneficiary's Presentation of Documents'.

16.5.1 Discussion between the banks and the beneficiary

The necessity to give the beneficiary a notice of dishonour within a time following the date of receipt of documents not exceeding seven banking days and under all circumstance is another basic principle enforced on all banks involved in standby letter of credit. (Rule 5.01, Chapter 6).

The notice of dishonour is given by an authenticated telecommunication message mostly via SWIFT through a bank (nominated bank/confirmer) to the beneficiary. If the documents are directly received from the beneficiary

by the nominated person or confirmer, the notice may be given by mail, fax or any other expeditious means acceptable to the beneficiary. The notice of dishonuor may even be given orally provided a written confirmation is sent immediately afterwards.

The beneficiary, upon presenting the documents to the nominated bank that has agreed to act upon its nomination, may be advised by that bank that the documents are discrepant. The bank may also return the presentation in its totality to the beneficiary in order to amend/cure the discrepancies and represent the documents in conformity with the credit terms. The beneficiary will then cure the documents and represent them to the bank. The bank will start calculating the time again for re-checking from the next following banking day. Hence the presentation is considered as a new one and as such the checker will check every document on its own.

Where the documents checker of the bank concerned advises the beneficiary of the discrepancies and only delivers to it those discrepant documents whilst keeping the conforming ones with them, the document checker will consider the date of receipt of the last document as the date of presentation and will start calculating the time for checking documents on the business day following the date of receipt of the last cured documents from the beneficiary. Here care must be taken to ensure that the fresh presentation is not made after the expiry date or the latest date allowed for presenting documents under the standby letter of credit. Validity date discrepancies often occur after similar arrangements.

The beneficiary, may alternatively approach the applicant and obtain its approval to waive the discrepancies and as such it will instruct the bank to contact the applicant for this waiver.

Of course the bank handling the documents may chose in its sole discretion, to contact the issuer directly requesting the applicant's waiver of any discrepancies which the beneficiary could not cure or else an authorization to effect payment regardless of discrepancies which would only materialize if there is an agreement between the applicant and beneficiary.

Occasionally the beneficiary may disagree on the discrepancies with the nominated bank or confirmer and will insist on receiving payment. Here the bank may either insist on the discrepancies or else may accept to effect payment with recourse against an indemnity by which the beneficiary undertakes to refund the full amount with interest due if the documents are rejected by the issuer, the applicant or the confirmer, if any.

If the nominated bank acting upon its nomination has paid, accepted drafts, undertaken to pay or negotiated against an indemnity and then drawn the attention of the issuer or confirmer, as the case may be, to the noted discrepancies advising that honour was made against an indemnity, the issuer or confirmer will not thereby be relieved from any of their responsibilities to check the documents in accordance with the provisions of the ISP98

against the standby stipulations. Furthermore, upon forwarding the documents to the issuer, the presenter is precluded from objecting to the discrepancies notified to it by the issuer (Rule 5.06 Issuer Request for Applicant Waiver upon Request of Presenter).

Banks usually accept their own pre-printed indemnities prepared by their legal departments in standard forms.

16.5.2 Dispatch of documents to the issuer

The bank handling the presentation must carefully check the instructions in the credit regarding the precise place to which the documents must be dispatched and the designation or the person who must receive them. The provisions of Rule 3.01 of the ISP98 explicitly signify the importance of demanding the presentation of documents at a specific location in a specific place to a specific person in that location. And unless the documents are so dispatched, they will not be considered as complying (Rule 3.04 (a)).

16.6 REMITTING THE STANDBY PROCEEDS

If the documents are examined and found to be compliant, the document examiner needs to calculate the amount that must be paid in settlement of the reimbursement claim made under the standby letter of credit by either the nominated person or the confirmer who honoured the beneficiary's compliant presentment. The first two points that need to be checked are the settlement instructions stated on the remitting bank's covering schedule encompassing the compliant set of beneficiary's documents, and secondly the text of the standby credit to ascertain whether the charges to be paid are for the beneficiary's or applicant's account so that the credit amount may be deducted accordingly if charges are for the account of the former.

Where the credit is issued in a currency different from that of the country where the bank authorized to honour is located, the issuer almost always includes in the credit reimbursement instructions which permits the paying, accepting, negotiating or confirming bank (i.e. the bank authorized to honour), as the case may be, to lodge a reimbursement claim on a third reimbursing bank with which the issuer maintains an account in the currency of the credit under a complete correspondent banking agreement often referred to by the Agency Arrangement. There are occasions, however, where reimbursement can be executed through the Nostro and Vostro account of the correspondent bank without having to go through a third reimbursing bank; this is mostly done when the paying, accepting, negotiating or confirming bank has an account with the issuer in the same currency as that of the standby letter of credit. The direct settlement process can also be

efficient whenever the credit is in the same currency as that of the country at which the paying, accepting, negotiating or confirming bank is located, the bank may be able to instantaneously debit the issuer's account with them in reimbursement of the honoured amount of the presentment.

The credit may provide that reimbursement is to be made by lodging the reimbursement claim on the issuer itself rather than referring to a third reimbursing bank.

16.6.1 Means of remitting the reimbursement amount

Nowadays, SWIFT is the prevailing method for remitting the proceeds of a credit. Banks invariable prefer such methods for various reasons including the following:

1. Security: Automatic authentication of all messages as opposed to the inefficient way of the manual resolve of the test key number in transfers effected by telex.
2. Controlled Operations: SWIFT also entails controlled communications and fewer operational problems since the message can only be released once all the field are completed.
3. High level of efficiency: The unified numbers of the various fields of each message and the unified numbers of various types of messages according to their specific function often make it possible to link the trade finance automated system of the bank with the SWIFT itself and thus the interface allows the exchange of messages with the Cables Department automatically rather than having to go through the lengthy manual procedures.

16.6.2 The general SWIFT messages type under letters of credit

Reimbursement Authorization – MT740

Reimbursement Claim – MT742

Advice of Payment/Acceptance/Negotiation – MT754

Advice of Reimbursement or Payment – MT756

Customer Transfer – MT100

Free Format Message – MT777

The Uniform Rules of Bank-to-Bank Reimbursement (URR – ICC) govern any standby letter of credit transaction subject to the ISP98.

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ABOUT J. SIFRI CONSULTING SERVICES (JSCS)

Constituted in 2002, *JSCS* have succeeded to establish themselves as a group of professional banking consultants. With over 100 years of collective banking experience and internationally respected professional qualifications, our team remains the ultimate reference for banking authorities seeking to augment their institutions with sophisticated systems of operations, technical skills and management plans essential to foster faultless, low risk and world class customer service.

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J. Sifri Consulting Services

JSCS announces the commencement of the ISP98 rules of practice and the standby letters of credit, an in-house training course for letters of credit practitioners

The Course Objectives:

- To gain an awareness of the wide use of Standby LCs by banks.
- To understand the different types and uses of Standby LCs.
- To understand the sound application of the ISP98 rules in day-to-day banking operations rather than develop an abstract legal perspective on the subject.
- To understand and appreciate the operational risks of Standby LCs.

Issues Covered:

A. Standby letters of credit – introduction and definitions
B. Types and uses of standby documentary credits
C. Roles and responsibilities of parties to the standby credit
D. Sound application of the ISP98 rules of practice in day-to-day banking operations
E. Checking documents of a standby LC presentation
F. Handling presentation and settlement
G. Bank-to-bank reimbursements

DURATION: 5 Days (25 Training hours)
TRAINEES: Maximum 15 persons per course
MATERIAL: THE BOOK *STANDBY LETTERS OF CREDIT – A COMPREHENSIVE GUIDE.*

For more details, kindly visit our website www.graincon.com or email us general@graincon.com.

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You are cordially urged to visit our website
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JSCS announces the commencement of

Practical Letters of Credit Program

An in-house training course for bankers at all levels and ranks

Course Objectives:

To understand the importance of trade services to the bank.
To appreciate the complexity of LC operations and understand related risks.
To learn the sound application of the LC rules of practice instituted by the ICC.
To understand the different types and uses of the LCs.
To learn how to handle presentations.
To learn the art of checking documents.

Issues Covered:

A. Types and uses of documentary credits
B. Parties to the documentary credit transaction
C. Roles and responsibilities
D. The Incoterms 2000
E. Issuance
F. Checking documents
G. Settlements
H. The risk issues pertaining to letters of credit operations

DURATION: 5 Days (25 Training hours)
TRAINEES: Maximum 15 persons per course
MATERIAL: About 100 pages superbly presented, covering the whole subject from a practical banking perspective

For more details, kindly visit our website www.graincon.com or email us general@graincon.com.